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STATE OF NEW YORK

SPECIAL REPORT

OF THE

STATE TAX COMMISSION

No. 6

THE ALLOCATION OF CORPORATE INCOME FOR THE PURPOSE OF STATE TAXATION

By

Robert S. Ford
New York State Fellow in Taxation at Columbia University
Research Investigator, New York State Tax Commission
Instructor in Economics, Columbia University

Submitted in partial fulfillment of the requirements for the degree of Doctor of Philosophy, in the Faculty of Political Science, Columbia University

ALBANY
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1933

FOREWORD OF STATE TAX COMMISSION

This is the sixth special report under the plan inaugurated in 1928 pursuant to the provision of the Tax Law of New York State requiring investigations to be made from time to time of the general system of state taxation. The author of this particular work is Dr. Robert S. Ford of Columbia University. The State Tax Commission wishes to acknowledge its indebtedness to Columbia University and particularly to Professor Seligman for selecting Mr. Ford to make this study on the allocation of corporate income for the purpose of state taxation.

MARK GRAVES
President

JOHN MERRILL
JOHN P. HENNESSEY
Commissioners

M. S. HOWARD
Deputy Commissioner, Bureau of Research

PREFACE

This report is an attempt to state and analyze a problem that is just beginning to receive general consideration. It represents, therefore, a pioneer investigation of a field that will repay more intensive cultivation. The allocation of corporate income among several different taxing jurisdictions is a relatively new phenomenon in this country. Since 1911, almost one-half the states have adopted the so-called corporation income tax for mercantile and manufacturing corporations, nine states having adopted such a tax within the last three years. The rapidity of this transition has created many new problems in taxation, some of which could have been avoided if there had been any real stimulus to the adoption of similar practices by the states. This is particularly true of the allocation problem, which by its very nature involves the bringing into contact of two or more tax systems. Perhaps no other phase of the fiscal system, with the possible exception of inheritance taxation, represents so clearly the nature of tax frictions. The chief purpose of this report is to analyze the nature of the friction which arises out of non-uniform allocation practices and to suggest possible methods of reform.

It is difficult to make acknowledgments to all who have offered suggestions and criticism during the course of this investigation. The writer wishes to express his gratitude to Professor Edwin R. A. Seligman under whose guidance this study was undertaken. He is indebted to Professor Robert M. Haig for much searching criticism and many constructive suggestions. A great deal of assistance was rendered by Commissioner Mark Graves, Deputy Commissioner Mayne S. Howard and Miss Beulah Bailey, State Tax Librarian. Several of the tax officials in other states have been generous in supplying information regarding allocation practices.

R. S. F.

New York City
March, 1933

CONTENTS

INTRODUCTON

Nature of the Problem

At the present time, twenty-one states levy a tax on the income of mercantile and manufacturing corporations. In the theory and administration of this tax, one of the most puzzling problems arises out of the allocation of income among the states for taxation purposes. Essentially the problem is twofold, involving the questions of method and non-uniform practices.

The question of method relates to the manner of determining the proportion of a company's income which is taxable within a certain state. If a corporation operates in several states, each jurisdiction will claim a portion of the net income for taxation purposes. But how shall these claims be measured? The state may require the use of certain allocation criteria, the so-called allocation fraction, or it may permit the taxpayer to allocate income to the state on the basis of the company's accounting records.[1]

The most common practice in the American states is to use certain arbitrary criteria, such as tangible property and sales within and without the state, in distributing the tax base. Serious complications arise, however, out of the selection of these criteria, for not infrequently the states are motivated strictly by revenue considerations, and as a result the criteria are not representative of business activity in general. Criteria which are favorable to one state may be unfavorable to another. It has been contended that no arbitrary ratios are sufficiently representative of business activity within a state to warrant their application to all corporations; that instead of requiring the use of an allocation fraction, the tax-paying corporation should be allowed to determine the amount of income apportionable to each state on the basis of standard accounting procedure.

The prevalence of non-uniform allocation practices among the states is deplorable. Under the stimulus of an individualistic political philosophy, a haphazard allocation structure has been erected. No less than twelve different allocation formulae are in use in the twenty-one states with taxes on income. In the search for larger revenues, a premium has been placed on ingenuity in the formulation of allocation rules. As a result, the possibilities for double taxation have been greatly enhanced.

Within recent years, the allocation problem has assumed large-scale proportions because of the changing character of industrial organization. Corporate interrelationships have become more

[1] It should be noted that the following terms are used interchangeably throughout the report: allocation base, allocation criterion, allocation ratio, allocation factor; the terms, allocation fraction and allocation formula, are used to denote a combination of several bases, ratios, criteria or factors.

complex. The activities of many corporations have been projected beyond state and national boundaries. Many of the difficulties arise out of the fact that the taxation machinery of the states is inadequate to meet the requirements of modern industrial organization. Recent decades have been characterized by increasing industrial integration, while fiscal integration is practically non-existent. Consequently, a problem of interstate and international proportions is being handled with an intrastate technique.

Methods of Reform

Greater reliance should be placed upon the accounting records of corporations. Many concerns are equipped to make full and accurate reports of the amount of income arising within various jurisdictions, and in such cases an income tax return which is based on company records should be acceptable. Nevertheless, it will appear in the report that arbitrary criteria cannot be entirely abandoned, especially if the regulation of allocation practices should be centralized in the federal government.

Diversity in allocation practices may be eliminated in several different ways. In the first place, the *status quo* in governmental relationships may be maintained through interstate agreements for the adoption of a uniform rule. To anticipate such a solution, however, one must be an incorrigible optimist. The various states will not renounce voluntarily their claims to substantial amounts of taxable income. This plan would involve the scrapping of eleven different allocation methods for the adoption of a uniform rule, which perhaps would yield less revenue for some states.

Another solution to the problem of non-uniformity involves a reorganization of federal and state relationships. As Professor T. S. Adams has stated, the allocation problem is an "extraordinary problem and may require an extraordinary solution." Such a reorganization may be effected along several different lines, two of which are significant for the purpose of this investigation. In the first place, the "crediting principle," which is used in connection with the estate and inheritance taxes, might be extended to the corporation income tax with the provision for the adoption of a uniform allocation procedure by the states. This would involve an indirect form of federal pressure.

A more thorough-going solution to the problem could be accomplished by an integration of federal and state systems of taxation with federal administration. The problem of allocation would still be present, but it would be shifted to the federal government, which would have to select a method for the distribution of tax proceeds among the states. In returning the proceeds of the corporation tax, either the plan of the committee of the National Tax Association or the Massachusetts rule of allocation might well be followed. Under this arrangement, non-uniformity in allocation practices, which is one of the greatest obstacles to a solution of the problem, would be automatically eliminated and the groundwork would be laid for a permanent reform.

General Plan of the Report

The allocation problem is so comprehensive that it has been necessary to limit the present investigation to mercantile and manufacturing corporations, or the so-called "business corporations." It is not the intention to concentrate on the allocation method of any one state, but rather to study the implications of non-uniformity in the practices of several states. In following out this purpose, the procedure is as follows: first, to examine the legal and economic bases of the allocation problem and to analyze the question of method; second, to describe the chaotic situation which prevails in the states; third, to analyze the results of non-uniform practices; fourth, to compare the model proposals which have been made for the solution of the problem, all of which are predicated upon the condition of uniformity; and, finally, to consider the methods of accomplishing uniformity in allocation practices.

PART I

LEGAL AND ECONOMIC FOUNDATIONS OF THE PROBLEMS

CHAPTER I

PROBLEMS IN THE DISTRIBUTION OF THE TAX BASE

Income Subject to Allocation

The allocation of corporate income among two or more states is one part of the general problem of distributing the tax base. The first question to be considered relates to the composition of the tax base and consequently the income to be distributed among the taxing states. In general, the corporation income tax is levied on net income which remains after the exemptions and the expenses of doing business are deducted from the gross receipts. The measure of the tax in each state consists usually of the net income which arises from sources within the state. It is not an easy task, however, to determine the real sources of specific portions of income. There are certain classes of income which may be specifically allocated to sources within a given state and which should not be included in the income to be apportioned. For instance, dividends, interest, rentals and royalties may be allocated to the state in which the investment is made or the property is located; gains from the sale of capital assets, or property other than the stock of merchandise that is sold in the regular course of business, may be allocated according to the location of the property. After these items have been deducted, there remains a lump of income, so to speak, which is to be distributed among two or more states for taxation purposes. The method of distributing this income represents the heart of the allocation problem.

The Significance of Arbitrary Allocation Criteria

For industry as a whole, there is no clear-cut line which separates the income to be taxed by one state from that to be distributed among several states. On a strict accounting basis, a fairly precise distribution of taxable income could be effected. The states, however, have resorted to arbitrary criteria in determining the income which arises from business conducted within their own borders. As might be expected, no state has ignored its own revenue requirements. For instance, if manufacturing predominates within one state and sales within another, each state will usually select an allocation formula which will reflect and, in fact, magnify the particular activity which is carried on within the state. For this reason, the selection of allocation criteria has become a problem of great significance. It is the purpose, in this chapter, to analyze the bases as well as certain problems arising from the use of arbitrary allocation criteria.

Functional Classification of the Source of Income

The selection of arbitrary allocation criteria is predicated on the assumption that these criteria adequately reflect the amount of

income arising from various sources. In general, business activity represents the source of corporate income, but such activity may be classified according to the functions of manufacturing, buying, assembling or processing, storing or warehousing, and selling. It is chiefly on the basis of these functions that the states claim the right to tax business income and the existing allocation criteria reflect, in varying degrees, the performance of these functions within the states.

The Relative Importance of Various Business Functions

In the construction of an allocation fraction, a fundamental question arises which relates to the relative importance of manufacturing, buying, etc. Does the presence of all of a company's manufacturing equipment within a certain state entitle that state to tax all or only a portion of the total net income? For instance, let it be assumed that a corporation is engaged in a combined manufacturing and selling business which is spread over several states. About half of its real estate and tangible personal property is located within the state of manufacture, while the remainder of such property is located in other states where the sales occur. Can it be assumed that one-half, or less, of the net income should be allocated to the state of manufacture for taxation purposes?

A situation similar to the assumed case arose in the state of Connecticut, which has an allocation formula based on the ratio of property within and without the state. In a famous case,[1] it was shown that a corporation had forty-seven per cent of its real estate and tangible personal property within Connecticut, while eighty per cent of its gross earnings arose from the sale of manufactured products outside of the state. Under the Connecticut rule, the corporation was taxable on forty-seven per cent of its income.

What is the relative importance of the manufacturing, buying, warehousing and selling functions in the case of a Delaware corporation which has its manufacturing plant located in Massachusetts, purchases its raw materials in Connecticut, warehouses the goods in New Jersey, and sells its finished products in Pennsylvania, New York, and Ohio? The same question might be asked with reference to thousands of corporations in this country[2] but

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[1] *Underwood Typewriter Company v. Chamberlain*, 254 U. S. 113 (1920). Discussed at P. 38.

[2] The danger of a general rule relative to the importance of manufacturing, selling, warehousing, etc., is realized in scanning Poor's Manual. The following cases are typical:

Aluminum Co. of America

"Owns bauxite deposits in Saline County, Arkansas, from which it secures some of its aluminum ore. The most of the company's ore comes from South America. The mining plant in Arkansas has in operation crushing and drying apparatus and a short connecting railroad between the plant and the Rock Island and Iron Mountain Railroads. The bauxite is shipped to a refining plant at East St. Louis, Illinois, where

no categorical answer can be given; each case must be handled according to the facts and circumstances. The variety of industrial conditions seems to preclude generalization. The opinion prevails widely that to secure even an approximately satisfactory

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the impurities are removed. Company has reduction works where aluminum is made at Niagara Falls and Massena, N. Y., Alcoa, Tenn., and Badin, N. C.; also a wire and cabling mill at Massena, a general fabricating plant at New Kensington, Pa., a plant for the manufacture of aluminum bronze powder and aluminum foil at New Kensington, Pa., and rolling mills at Niagara Falls, N. Y., Edgewater, N. J., and Alcoa, Tenn.

General Mills, Inc.

"Company is the largest producer of flour in the world, and, in addition, produces a complete line of commercial feeds and various cereal products . . . Branch offices are maintained in 69 cities. Company owns and operates mills located in 23 different cities. . . . The largest mills are located in Minneapolis and Buffalo. . . . Other mills are located in Illinois, Kentucky, Kansas, Oklahoma, Texas, Montana, Washington, California, Missouri, Oregon, Ohio and Utah. In addition to these facilities for flour manufacturing, the Company owns and operates eight plants for the production of special and poultry feeds, two modern plants for the manufacture of cereals, valuable water power rights on the Mississippi and Missouri rivers and a complete experimental farm near Detroit, Michigan.

Crane Co.

"Established . . . to manufacture and deal in valves and fittings in brass and iron for all pressures of steam, gas, oil and water; steam specialties, wrought and steel pipe, etc. . . . Plants located at Chicago, Bridgeport, Conn. . . . Birmingham, Ala.; and North Tonawanda, N. Y.; branches in New York, Philadelphia, Cincinnati, Kansas City, Omaha, Sioux City, St. Paul, St. Louis, Los Angeles, San Francisco, Portland, Oregon, Boston, Baltimore, Birmingham, Atlanta, Jacksonville and New Orleans, etc. In all, Crane Co. of Chicago and its affiliated companies, the Crane Company of Minnesota and Crane-O'Fallon Company, Denver, Colorado, had, as of December 31, 1930, 150 branch houses, 9 sales offices and 4 large exhibit rooms (New York, Atlantic City, San Francisco and Chicago) in the United States, 19 branch houses in Canada, 2 branch houses and 4 sales offices in England, 1 branch house in France, 1 in Belgium, 1 in Mexico, 1 in Cuba and 1 in Brazil and 4 sales offices in India.

Kroehler Manufacturing Company

"Company manufactures living room furniture,' . . . Company and its subsidiaries operate nine modern and complete furniture manufacturing units. . . . Plants are located at Naperville, Illinois, Kankakee, Illinois, Bradley, Illinois; Binghamton, N. Y.; Dallas, Texas; Los Angeles, California; San Francisco, California; Chicago, Ill., and Cleveland, Ohio.

The Great Atlantic & Pacific Tea Company of America

"The company controls through stock ownership companies operating chain groceries and meat markets in 35 states in the United States and in 2 Provinces in Canada. These stores are supplied by 53 warehouses located in principal cities. The subsidiaries also operate 35 bakeries, 23 produce warehouses, two butter warehouses, one fish warehouse, one creamery, nine milk plants, seven coffee roasting plants, six salmon canneries, nine manufacturing plants, three cheese plants, two laundries and one printing plant. As of February 28, 1931, company operated 15,737 stores." Poor's Manual, Industrial Section (1931) *passim*.

solution several factors must be used; for example, the location of property and the situs of sales,[3] with the former being weighted at, say, two-thirds and the latter at one-third.[4]

The Rule of Unity Versus the Separate Entity Concept

A fundamental phase of the allocation problem relates to the question as to whether a concern should be considered as a unitary enterprise or as a consolidation of separate units.[5] According to the so-called "rule of unity," an enterprise is considered as an economic unit regardless of the geographical scope of its activities. The argument runs as follows: an integrated concern which is engaged in manufacturing in one state, warehousing its product in another state, and selling in several states constitutes a unitary enterprise because the profits arise from a series of transactions which begin with the manufacture in one state and end with the sale in other states, and at no point along this sequence of activities should there be an independent accounting. Profits are not realized until completion of the final sale.

The concept of a separate entity is the obverse of the rule of unity. Historically, the question of distinguishing between a separate-entity and a unitary concern was of little significance for the two were usually synonymous. Business activities seldom extended beyond state boundaries and there was not the confusing array of affiliated companies. This tradition has been preserved in the law. Legally, a concern may organize ten, or even a hundred, subsidiaries in different states, all of them being, nominally, separate corporations; economically, they are simply parts of a unitary enterprise. However, the economic relationship does not preclude an accounting for each unit of the enterprise in order to determine its financial status. The separate entity concept is predicated upon the assumption that either the individual units or functions of an integrated industry can be separated for the computation of an independent profit or loss.[6] If complete data

[3] But there is an absence of agreement regarding the situs of a sale. The whole question is shrouded in uncertainty.

[4] Several allocation formulae are predicated upon this assumption. See Part II of the report.

[5] The significance of this distinction will be realized more completely in connection with the problem of allocation methodology, which is presented in the next chapter. The use of a fractional apportionment is predicated upon the rule of unity, while the "separate entity" concept is based on the assumption that the branches of an enterprise are separate business units and may be treated as such for accounting purposes. Legally, both methods are acceptable, although, when fractional apportionment is required by the statute, separate accounting will be upheld only if it can be shown that the allocation fraction operates unfairly against the taxpayer.

[6] It must not be supposed that the separate accounting method is predicated entirely upon the "separate entity" doctrine. Many of the states allow corporations to make a return of taxable income on the basis of a separate accounting, but in connection therewith the states may permit or require a consolidated return of income. This is a fairly recent practice among the states and represents a new emphasis upon the unitary theory.

relative to costs and prices are available, it may be possible to compute the manufacturing, buying and selling profit and to segregate the profits according to the jurisdiction in which they are earned.[7]

In view of the complexity of modern intercorporate relationships, it is futile to argue the question as to whether a selling unit, or some geographically-separated subsidiary, constitutes a separate entity or is an integral and inseparable unit of the whole enterprise. In the past a great deal of the confusion arose out of the legal conditions surrounding the question, but within recent years both theories have received judicial sanction.[8]

Relations Between Parent and Subsidiaries

A basic problem arising out of the concept of economic unity relates to the case of a large concern, operating in several states, which shows a loss on its entire business, but a profit from its operations within a single state. Should the entire profits of the prosperous unit be taxed in the state where it is located or should the prosperous unit be considered a part of a losing venture? Legally, the jurisdiction in which the profit was earned is entitled to levy a tax. If the concern be regarded as an economic unit, however, the net income of the profitable branch is offset by the losses of other branches of the business. It has been argued by some that competitive conditions may warrant the assignment of a part of the loss to a profitable unit. For example, assume that a corporation manufactures in one state and transfers the goods to a selling subsidiary in another state and that competitive conditions become so altered that the subsidiary is forced to sell the goods at a price below the figure at which they were billed to it by the manufacturing unit, or even below the actual costs of production. Under such conditions, there would be a case for assigning a portion of the loss to the unit which was unaffected by changes in competition. On the other hand, if the income has been computed in the regular manner, the profitable unit being charged with its fair share of the overhead expenses, some contend that no portion of the loss should be assigned to it.

The obverse of the original case may be assumed, *viz.*, a large enterprise which operates in several states may show a profit as a whole, while a subsidiary within a given state shows a loss. Complexity has been injected into this situation because of the legal technicalities. A case arose in New York[9] in connection with a British corporation which reported no net income in this country,

[7] However, it may be necessary to pro-rate certain items of cost, such as "overhead," by some arbitrary rule. See P. 25.

[8] Rule of unity: *Underwood Typewriter Company v. Chamberlain*, 254 U. S. 113; *Gorham Manufacturing Company v. Travis*, 274 Fed. 975. Separate entity: *Standard Oil Company of Indiana v. Thoresen*, 29 Fed. (2d) 708; *Hans Rees' Sons v. State of North Carolina*, 51 Sup. Ct. 385 (1931). See Chapter III.

[9] *Bass, Ratcliffe and Gretton, Ltd. v. State Tax Commission*, 133 N. E. 122, 266 U. S. 271. Discussed at P. 40.

although a considerable profit was made in England. The New York Tax Commission assessed the franchise tax, which is measured by entire net income, and it was upheld by the Court of Appeals. According to the New York law, corporations are required to make an apportionment of income on the basis of the proportion which certain assets within the state bear to the total of such assets.[10] The net effect of this practice is that a corporation may be required to pay the franchise tax even though it operates at a loss within the state.

The conditions discussed in this section are not uncommon and may arise because of the complicated intercorporate relationships that have developed. However, tax officials are inclined to regard conditions of this sort with suspicion because many corporations manipulate their accounts in order to show a loss from business operations in certain jurisdictions.[11] Frequently, it is very difficult to make a subsidiary report the income that is actually realized. For instance, the Studebaker case[12] involved a foreign corporation in New York, all of whose stock was owned by another foreign corporation. The parent company showed a profit, while the New York subsidiary, as well as the other subsidiaries with one exception, reported a loss. The losses, however, were absorbed by the parent company. Nevertheless, through a legal technicality the company was enabled to avoid payment of the tax. In this case, the losses were irregular and nominal; actually, they were not losses at all. The perpetuation of such legal obstacles retards a real recognition and settlement of this problem.

Consolidated Returns

In the case of a whole enterprise which shows a loss, but a profit within a single unit, or vice versa, it is apparent that the amount of taxable income which is reported may depend somewhat upon the form of the tax return. Should the concern be required to file a consolidated report of its income or should each unit be allowed to make a separate return?[13] In the case of an affiliated group of corporations whose activities are spread over several states, the income that is reported by any single unit of the group may be affected considerably by inter-company transactions, many of which are of an artificial nature. In a consolidated return, these items are usually "washed out." It has been shown that

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[10] See P. 60.

[11] In this connection, see Magill, "Allocation of Income by Corporate Contract" (1931), 44 *Harv. L. Rev.* 935. See also P. 47.

[12] *Studebaker Corporation of America v. Gilchrist,* 244 N. Y. 114. See P. 52.

[13] In general, companies do not have the option of filing consolidated returns to the states. Whether such a return shall be filed is usually left to the discretion of the tax officials, and these individuals "have shown a decided disinclination to permit consolidated returns"—National Industrial Conference Board, *State and Local Taxation of Business Corporations,* (1931) P. 78.

the situation may arise in which a subsidiary operates at a ridiculous loss, while the concern as a whole shows a profit. Another aspect of the same situation is that the group as a whole may show no federal net income, while the members that are located in some state, e. g. Connecticut, show taxable income.[14] In many instances, such a condition is legitimate. The chief difficulty is that all transactions between corporations which are owned or controlled by the same persons appear to be artificial because they have not met the test of dealing at arm's length. This problem is further intensified in state taxation by the fact that some corporate members of an affiliated group are usually located outside the local jurisdiction.[15] A further difficulty arises when the consolidated corporations are not engaged in the same or similar business and also where there are variations in the percentage of return per dollar invested.[16]

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[14] See *Singer Manufacturing Company v. Gilpatric,* 98 Conn. 192, in which the Connecticut members were held taxable.

[15] Ralph C. Jones, "Present Problems of the Consolidated Return" (1929), *Proceedings,* National Tax Association, P. 420.

[16] Ralph S. Marshall, "What is Income for New York Franchise Tax Purposes", *The Tax Magazine,* March 1931.

CHAPTER II

METHODOLOGICAL ASPECTS OF INCOME SEGREGATION

Problem of Method

The most controversial phase relating to the distribution of business income among the states for taxation purposes is of a methodological nature. The issue is focused by the question: should the distribution be effected by the method of separate accounting or by the more arbitrary procedure of an allocation fraction. In this distinction really lies the key to the whole problem. Theoretically, the use of a fractional method should allocate the same amount of total net income to the several states as would be available if each corporation were permitted to calculate its own taxable income according to standard accounting procedure. Unfortunately, it is impossible to obtain sufficient data for measuring the extent to which this ideal is attained. In the sequel, however, it is indicated that the existing non-uniform practices may lead to taxation of more income—frequently exceeding one hundred per cent of the taxpayers' income—than would be taxed if separate accounting or a uniform fractional method were followed.

Types of Allocation Methods

✓ FRACTIONAL APPORTIONMENT.—The method of fractional apportionment is an arbitrary substitute for a detailed allocation of expenses and revenues. The mechanical device for accomplishing such an apportionment is called the allocation fraction and it has been defined as the "means whereby the total net income or the total valuation of a business concern is split up to give a situs in a given jurisdiction to avoid the well-nigh impossible task of assigning to that jurisdiction, item by item, the specific elements of income or value which would be accounted for in that jurisdiction if the business done therein were considered a separate accounting unit."[1] Under such a device, the income is allocated to the states according to the proportions, within and without the state, of certain arbitrary elements, such as sales, property, certain expenses or some combination of these items. According to this method, "a general fraction is applied to the entire net income, and a fractional share of the entire net income of the whole business is allocated or assigned to the foreign state or jurisdiction which is attempting to impose the tax."[2]

[1] Gerstenberg, C. W., "Report of Committee on Standardization and Simplification of the Business Taxes" (1929), *Proceedings*, National Tax Association, P. 152.

[2] Adams, T. S., "Allocation versus Apportionment" (1931), *Proceedings*, National Tax Association, P. 346.

SEPARATE ACCOUNTING.—A strict application of the separate accounting method involves the treatment of a branch of the business enterprise as an independent entity or as a separate accounting unit. A subsidiary, of course, is considered as an independent corporation. Such a separation of units within an enterprise may entail the calculation of selling profit, as distinct from manufacturing profit or from buying profits. Furthermore, it is recognized that separate accounting consists not of a single method but of many different methods which will vary according to the conditions within an enterprise.

As contrasted with the arbitrary character of an allocation fraction, this method is relatively exact. The two methods, however, "are not absolutely distinct. Under separate accounting, many expenses and some receipts must be allocated by pro-rating on some appropriate basis.[3] Pro-rating is a species of fractional apportionment; but under the method of separate accounting pro-rating is used only where necessary, and then the basis of the pro-rating varies with each expense or item of revenue in question. Moreover, and more important, under a method of separate accounting, functions and departments of the business not represented in the foreign tax jurisdiction, do not come into the picture at all .... The essential difference between the two methods is found not so much in the use of what may be called fractional pro-rates, as the application of such pro-rating to the entire net income."[4]

It is beyond the scope of this study to analyze the various accounting methods that may be followed by a large enterprise in determining the profits attributable to the activities within a single state or in segregating the manufacturing, selling and buying profits. It is obvious, however, that a detailed distribution of taxable income is preferred by many concerns, and particularly those which are equipped with adequate accounting facilities.

EMPIRICAL METHODS.—Empirical methods are used frequently in England, Germany and France and by the federal government in the United States. In general, this type of allocation is resorted to as an alternative to separate accounting and in preference to a fractional apportionment.

> The usual reason for disregarding the results of the separate accounts and resorting to some empirical method is that the accounts show little or no profit. Not infrequently, this results from the enterprise invoicing goods to the branch at so high a price as to restrict the profit realized by the branch when the goods are sold, or to excessive charges made for interest, services, royalties, or on some other account. In view of the difficulties of ascertaining what is an appropriate invoice price, the tendency on the part of tax officials is not to try to ascertain a fair price but to turn at once to a comparison of the percentage of net profit to gross turnover of similar businesses, or to employ some other empirical method. . . . This percentage may be taken

[3] It may happen that some item of expense, such as "overhead," cannot be allocated definitely to any single unit of the undertaking, but must be apportioned on the basis of some presumptive rule, such as the ratio of gross receipts within and without the jurisdiction.

[4] Adams, *op. cit.*, P. 346.

as a basis for taxation in France, Germany and Great Britain, but in the United States it is ordinarily used merely as a lever to prevail upon the taxpayer to correct his accounts so as to reveal the true income.

Other empirical methods include: (1) assessment on the basis of an agreed amount, sometimes resulting from an estimate of income, sometimes from applying an agreed percentage to turnover, and usually employed over a period of from three to five years (Germany and Great Britain); (2) assessment on the basis of the normal rate of interest on the capital invested in the branch (Germany); (3) apportionment of total income in accordance with the ratio of turnover, of assets, or with a combination of both elements as is provided in the regulations of the United States Income Tax Act.[5]

The Case for Fractional Apportionment

Fractional apportionment seems well entrenched as the dominant method of allocating income among the American states. As stated previously,[6] the use of this method is predicated on the rule of unity. In an important case[7] on this point, the court held that "the profits were largely earned by a series of transactions beginning with the manufacture in Connecticut and ending with the sale in other states. . . . The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by processes conducted within its borders."

Various arguments have been advanced in support of the fractional method of which the following are of chief importance.

SIMPLICITY.—It is pointed out that the allocation fraction is a simple device, being based upon factors, such as property, sales, payroll, etc., which are fairly easy to measure. Only a few definite rules are necessary in making an apportionment of income, so that the problem is simplified greatly for the taxpayer. Many contentious questions which would arise in a state audit of corporate accounting records—such as the allocation of overhead expenses, interest paid on debts, deductions and other general expense items—are avoided.

In general, complexity is undesirable because thousands of corporations are engaged in a combined local and interstate trade. It is imperative, therefore, that a method be adopted which is readily applicable in the majority of cases. The fractional device meets this requirement.

Finally, the allocation fraction, from an administrative standpoint, is an economical and efficient method for distributing taxable income. To audit tax returns which were based strictly on accounting records of corporate taxpayers would cause increased administrative expense and greater delay than is involved in the administration of the fractional system. Elaborate administrative processes simply clog up the fiscal machinery.

[5] Carroll, M. B., "General Survey of Allocation Methods," *Taxation of Foreign and National Enterprises in France, Germany, Spain, the United Kingdom and the United States of America* (1932), League of Nations, Geneva, P. 21 f.

[6] P. 20.

[7] *Underwood Typewriter Company* v. *Chamberlain*, 254 U. S. 113 (1920). See P. 38.

THE ELEMENT OF "GOOD FAITH."—The proponents of fractional apportionment claim that this method is followed because of the unwillingness of the taxpayer to deal fairly with the government. The existence of "good faith," they say, cannot be assumed. If taxpayers were permitted to file income tax returns solely on the basis of their accounting records, there would be a temptation to resort to large-scale manipulation of accounts in order to reduce tax liability.

The negative aspect of this question, as well as the *raison d'etre* of fractional apportionment, has been cogently stated by Professor Adams: "The case for fractional apportionment rests largely on the inability or unwillingness of tax authorities to take the trouble to satisfy themselves about the good faith of returns made by individual taxpayers."[8]

FLEXIBILITY.—It is also claimed that the allocation fraction is not necessarily an inflexible device. Obviously, there is no single fraction or rule which is suitable for all industries. For this reason, provision is usually made for the use of an alternative rule if it can be shown that the statutory formula operates unfairly.

FREQUENT NECESSITY OF USING AN ARBITRARY METHOD.—Cases often arise in which the use of an arbitrary method seems unavoidable. For instance, a large concern which operates in several states may have more or less of a monopoly of the products in which it deals. The tax commissioner, in the process of auditing the tax return, will be faced with the difficulty of determining whether or not a fair billing price is used, that is the price at which the goods were sold by the factory in State A to the selling unit in State B. If the manufacturing concern were selling to an independent customer in State B, or if other concerns were engaged in a similar business, it might be possible to obtain comparative figures for checking the final and intermediate sales prices. In the absence of such concerns, however, no independent factory or production price will be available. It will be necessary, therefore, to resort to a fractional apportionment or to an empirical rule, and especially if there are reasons for doubting the integrity of the concern.

As an additional argument, "the testimony of experienced accountants is that a system of separate accounts for branches or subsidiaries is, in the majority of cases, impracticable."[9]

REVENUE.—It is contended that more revenue is obtained from the use of the fractional method than would be if the separate accounting method were generally adopted. There is no ground for such an assumption, however, unless corporations are taxed on more than one hundred per cent of their income. It is probable

[8] Letter from Dr. T. S. Adams to the writer under date of August 18, 1931.

[9] "Report of the Committee on Uniformity and Reciprocity in State Tax Legislation" (1931), *Proceedings*, National Tax Association, P. 306.

that a state which uses an allocation ratio consisting of property only, or of sales, or of a combination of property and sales, obtains more revenue than it would if a more equitable method—such as a combination of property, pay-roll and sales—were used or if a separate accounting were permitted.

UNIFORMITY.—The adoption of a uniform allocation rule is an essential presupposition to the advocacy of the method of fractional apportionment. The above arguments are of little significance unless predicated upon the condition of uniformity. If a uniform rule were followed, a fairly strong case for fractional apportionment could be made on the basis of simplicity alone.

Objections to the Fractional Method

There are many who hold that the theoretical deficiencies of fractional apportionment outweigh the administrative as well as the other advantages which are claimed in its behalf. Numerous objections have been advanced against the allocation fraction, of which the following are representative.

ACCURACY VERSUS SIMPLICITY.—The argument of simplicity, which is offered in support of fractional apportionment, is said to involve a subordination of accuracy to convenience and simplicity. The use of allocation ratios precludes consideration of the actual facts of the case inasmuch as the ratios are based upon presumptive indicia, such as property or sales within and without the state. Furthermore, it is doubtful if the system of fractional apportionment is approved by the majority of taxpayers. The relative scarcity of allocation cases before the courts is not an indication of satisfactory results with existing methods. In the case of many small concerns, the amount of tax may be too low to justify the time and expense which are involved in a legal proceeding. Finally, it is probable that any inclination on the part of the taxpayer to test the rule in the courts would be curbed by the tax commission through bargaining over the amount of tax to be paid.

/ ARBITRARINESS.—The most serious objections relate to the arbitrary character of the allocation fraction. After all it is doubtful whether a fraction that is based on certain selected factors will produce approximately the same results as a detailed allocation, or so much so as to warrant the abandonment of the latter method except in certain cases.[10] There are twelve different allocation fractions in use among the states, no one of which has been proven to be completely accurate. Comparative tests may indicate the superiority of one allocation formula over another, but this is no demonstration of the superiority of the method itself over that of a separate accounting.

[10] Likewise, the exceptions may be arbitrary. Massachusetts, for instance, permits foreign corporations, only, to calculate taxable profits on the basis of a separate accounting.

The allocation fraction is arbitrary and inadequate in many respects when applied to the profits of an integrated concern. A detailed accounting may be necessary in order to show, with a high degree of accuracy, the amount of income arising within different jurisdictions. A few of the inadequacies are indicated in the following cases, which, though not exhaustive, indicate the types of problems arising in this connection.

Case 1: Let it be assumed that a corporation is engaged in the production and sale of a commodity which is manufactured in State A, warehoused in State B, and sold in State C. A fundamental question is raised in this case relative to the weights which should be attached, in the allocation fraction, to the functions of manufacturing, warehousing and selling. Should manufacturing be weighted at fifty per cent or less? Is the selling function magnified unduly by being weighted at forty per cent? As a general rule, what percentage of the profits should be attributed to warehousing? Can a single set of percentages for allocating profits be prescribed for all corporations? In a previous section,[11] the difficulty of determining the comparative importance of manufacturing and selling was considered, the conclusion being that no categorical answer could be given. Further discussion here would be repetitive.

Case 2: An arbitrary feature in the application of the fractional method is illustrated in the case of a concern which manufactures two commodities in one state, only one of which is sold in another state. For instance, assume that a New York corporation is manufacturing two commodities, only one of which is sold in North Carolina and several other states. What is the result from an allocation standpoint? May North Carolina or any of the states in which the concern is engaged in business use the total net income from activities in all of the states as a basis for calculating its respective portion of the taxable income? It is probable that all of the states will apply the allocation fraction to the figure of total net income.[12] Strictly speaking, the fraction of each state should be applicable only to the income that is derived from the commodity which is manufactured or sold within its borders, that is, income from the two commodities should be segregated. To use the entire net income under such circumstances might work injustice against the taxpayer.

The legal aspects of this situation are illustrated in the Gorham Case.[13] The income of the enterprise, as reported to the federal government, included profits from a combined silverware and munitions business, the latter being localized in Rhode Island. The New York fraction, however, was applied to the entire net income.

[11] P. 18 *et seq.*

[12] Some of the states allow a credit, a few allow only a deduction for income taxes paid in other states.

[13] *Gorham Manufacturing Co.* v. *Travis*, 274 Fed. 975. See P. 38.

In upholding such an application of the New York fraction, the court said: "Any effort at allocation must be more or less arbitrary and fictitious. . . . in a business which is a unity, it is impossible to break up the parts and satisfactorily assign to any piece a corresponding part of the income."

Case 3: It happens frequently that a concern, in addition to its business of manufacturing and selling, derives income from investments, which are localized in a single state. Assume that a New York corporation, which is engaged in business in several states, shows a profit of $20,000,000, while an additional profit of $5,000,000 is derived from its investments in New York. The allocation to other states should exclude entirely the profits from investments. Nevertheless, some of the states attempt to tax a part of total income, although it may not be derived from business conducted or investments made within their borders.

Case 4: Finally, the allocation fractions in two states[14] are based on a segregation of assets which, under the legal interpretation of a franchise tax, may entitle the state to tax a portion of the profits even though nothing is earned within the particular state. Assume that a concern has one-half of its assets within State A, which requires that allocation be made on the basis of segregated assets. The enterprise shows a total net profit of $4,000,000, none of which is earned within State A. Nevertheless, fifty per cent of the assets are located within the state and, legally, it is entitled to tax $2,000,000 of the profits.

DISSIMILARITY OF INDUSTRIAL CONDITIONS.—Under fractional apportionment, a similarity of industrial conditions is assumed which is actually non-existent. Industries are not uniform and conditions vary among different enterprises within a single industry. No general apportionment formula can be constructed that will apply equitably to all concerns. Consequently, it is claimed that the fractional method leads to bargaining and vacillation.

GOOD FAITH.—It is asserted that there is as much reason for assuming the good faith of taxpayers as there is for doubting it.[15] The stimulus to tax evasion arises chiefly out of non-uniform taxing practices, which are followed by the states. It is probable that a minority, rather than a majority, of corporations, "milk" their subsidiaries in order to reduce tax liability. "Prorating fractions and other likely devices should not be adopted for fair taxpayers because they may prove convenient in the case of unfair and dishonest taxpayers."[16]

[14] New York and Vermont.
[15] See P. 27. It is recognized, of course, that good faith is stimulated by the administrative practice of charging penalties and additional assessments in the case of tax evasion.
[16] Letter from Dr. T. S. Adams to the writer under date of August 18, 1931.

Separate Accounting

THE SIGNIFICANCE OF THE BILLING PRICE.—There are many who claim that the use of the separate accounting method is impossible because of the absence of adequate accounting records or because the good faith of the taxpayer cannot be relied upon. A great deal of the difficulty lies in the matter of a fair billing price for goods that are transferred from one corporation to a subsidiary or to an associated company. This question is basic and deserves consideration before presenting the arguments.

In a segregation of manufacturing and selling profits, the amount of the latter is affected directly by the billing price at which goods are sold by the factory to a "selling subsidiary."[17] But what is a fair billing price? Apparently, that question can be settled only when an integrated concern is selling not only to its subsidiaries but to independent concerns as well. Or, at any rate, it is desirable in making a fair and impartial comparison that there be manufacturing and selling companies which are dealing with each other at arm's length, with no interlocking control. However, there are many difficulties in obtaining a true comparative picture. In the first place, the entire output of a concern may not be sold at the same price nor yield the same rate of profit. Secondly, what constitutes a similar business? If the test of similarity involved the dealers' price on automobiles, a true check would not result from a comparison of the billing prices between Chevrolets and Fords. Under such circumstances it may be necessary to disregard the accounting records and calculate taxable income according to the "percentage of turnover," or some other empirical rule.

Some companies follow the practice of making inter-company or inter-departmental prices according to which all goods that are sold to foreign subsidiaries or unincorporated branches are filled by the factory at jobbers' price, that is, the price at which the same goods are sold to independent jobbers. Such an "independent factory price" represents a billing price, which includes a proportionate share of overhead, general interest charges, etc., so that these items are automatically allocated. On the other hand, overhead and interest charges may not be included in the billing price, but allocated instead to the branch. In such a case, many difficult questions arise and it is often necessary to apportion overhead according to some arbitrary rule.

Another aspect of the billing price relates to its misuse in connection with tax evasion. It is an effective device for expanding the flow of profits into another state which has low rates of taxation or perhaps no corporate income tax. Analyses of the income tax returns of several concerns who sold to inde-

[17] When the profit arising out of these two functions is not separated, the goods are valued in the trading account at net manufacturing cost. Under the segregation method, however, they are carried to the trading account at a figure which represents a fair market price.

pendent jobbers revealed that the price charged to independents was much higher than the price of the same goods to a related company located outside the state.[18] An investigation of this sort consumes a great deal of time and money, and when it results in proof of an attempt to defraud the state the officials naturally become reluctant to leave the computation of taxable income to the discretion of the taxpayer.

The proponents of fractional apportionment claim that an independent factory price does not exist in a sufficient number of cases to warrant its general adoption as a basis for allocation procedure. Furthermore, in the absence of an independent factory price, little aid could be derived from the use of comparative prices. Under the circumstances, therefore, the use of an allocation fraction would seem to be the alternative.

Such a conclusion, however, does not necessarily follow. In the opinion of Professor Adams:

> It is possible, even probable, that where there is no true independent factory price, better results would be achieved by building up such a price, than by getting the answer through the rough and arbitrary process of a general apportionment fraction applied to the entire net income. It is quite possible that state tax commissions and other administrative bodies could lay down rules for determining the independent factory price that would be reasonably simple and fair to the taxpayer.
>
> This problem arises in acute form under the Canadian sales tax, and the administrative authorities seem to have no great difficulty in reaching a factory price, either by working back from the sales price (deducting therefrom a proper percentage for distributing costs and profit) or by adding to the factory cost of production a proper manufacturers' profit.[19]

OBJECTIONS TO THE USE OF SEPARATE ACCOUNTING.—*Expense and Difficulty of Administration.*—The expense of auditing returns, if the majority were filed on the basis of separate accounting, would be very high. Administrative difficulties increase as business becomes more highly integrated. It would be an impractical and almost futile procedure for a tax commissioner to undertake an audit of such highly-integrated concerns as the United States Steel Corporation or the Ford Motor Company. In order to obtain comparative statistics, it would be necessary to make a detailed investigation of enterprises that are engaged in a combined local and interstate trade; this would be expensive to the state.

Discrimination Unavoidable.—It is alleged that discrimination would inevitably arise because of the many detailed aspects of accounting procedure which would require interpretation. This would result in heavier taxes for some individuals and escape from taxation for others.

18 *Palmolive Company* v. *Conway*, 43 Fed. (2d) 226. This case is discussed at P. 49. See also Magill, Allocation of Income by Corporate Contract (1931), 44 *Harv. L. Rev.* 935.

19 Letter from Dr. T. S. Adams to the writer under date of December 7, 1931.

Impossibility of Standardizing Accounting Systems.—On account of the complexity of many accounting problems it would be difficult to formulate general rules to be followed by taxpayers in calculating taxable income. The peculiar conditions of industry necessitate a variety of allocation systems which cannot be standardized.[20] In the absence of such simplification of accounting technique, opponents of the separate accounting method claim that it would be impossible to provide an adequate administrative supervision.

Separate Accounting Theoretically Unsound.—It has also been contended that there is no economic foundation for the judicial sanction[21] of separate accounting; it is unsound theoretically and is inconsistent with the concept of economic unity. No profit is actually realized from any phase of an integrated business until the final sale is consummated. Business processes—manufacturing, warehousing and selling—cannot be separated for the computation of an independent profit. Some concerns make the mistake of calculating an accrued profit, which may vanish entirely if wide declines in price occur before the final sale is completed.

Creation of Friction between Taxpayers and Administrators.—Many administrative officials object to a separate accounting because they are anxious for simplicity in administration and the formulation of rules to be followed in a fairly uniform manner. It is claimed that "separate accounting is indefinite and leaves open too many disputable points to cause friction between the taxpayer and the official administering the law. Nearly every case involves the injection of some arbitrary factor...... It is better that these factors should be settled by the statute."[22]

THE CASE FOR SEPARATE ACCOUNTING.—The case in favor of separate accounting is apparent throughout the preceding sections which deal with the objections to fractional apportionment and to separate accounting. It is unnecessary, therefore, to state in positive form the possibility and advantages of developing such an allo-

20 According to Professor Hatfield, "It is impossible to frame a system of cost accounting applicable to establishments of different character. Iron works producing a single form of staple commodity, a factory making a few standard grades of cloth, each involving a succession of separate processes, works manufacturing special machines where it is desirable to learn the cost of the entire machine and of each of its parts, and a shipyard undertaking special contracts, each needs an entirely different system of keeping its cost accounts. No general scheme of forms can be outlined which will apply to all of them. Nor can a scheme be outlined which will apply in detail to the different individual establishments of a single class of undertakings. . . . Even to describe a system serviceable to a particular establishment . . . would require so extended a treatment as to exclude it from a treatise on the general principles of modern accounting." H. R. Hatfield, *Accounting, Its Principles and Problems* (D. Appleton & Co., New York, 1928), P. 397 f.

21 See P. 42.

22 Letter from Commissioner Henry F. Long of Massachusetts to the writer under date of September 22, 1931.

cation technique. The purpose of this section is to mention certain final considerations favorable to this method.

In the first place, it is not contended that the method of separate accounting could be used in every case. In the absence of an independent factory price, resort might be made to an empirical or to a fractional method. Secondly, under any system, certain individuals may attempt to manipulate accounts in order to reduce their taxes. This is a perennial difficulty, but it could be minimized somewhat if all of the states adopted the corporation income tax. Finally, a greater degree of uniformity in the accounting procedure of business corporations is desirable but not absolutely essential. Uniform accounting systems have been developed for the railroads by the Interstate Commerce Commmission and the public service commissions have prescribed detailed systems of accounts for street railways, gas companies and electric companies. From the detailed records which are required of these public utilities, it is fairly easy, in most cases, to segregate earnings for purposes of taxation. It is probable, however, that such a high degree of uniformity in accounting procedure would not be possible for business corporations. Nevertheless, many rules could be formulated for the allocation of income in specific cases and these could gradually be supplemented with more detailed requirements.[23]

Present Status of Methods

STATE.—The method of fractional apportionment is followed as a general rule in nineteen of the twenty-one American states which levy a tax on the income of business corporations.[24] Apparently, an empirical method is never used. In all but six of the taxing states,[25] however, some provision is made for the use of an alternative fractional method if it can be shown that the state formula operates unfairly.

Separate accounting is permitted in seven states [26] if the books of the company are kept in such a manner as to show the amount of income from operations in each state.[27]

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[23] For an excellent statement of the general accounting requirements and methods of adjusting accounts in the countries which place the greatest reliance on the method of separate accounting, see M. B. Carroll, "General Survey of Allocation Methods", *Taxation of Foreign and National Enterprises* (1932), League of Nations, Geneva, P. 23 f.

[24] Oklahoma adopted the corporation income tax in 1931, but no allocation formula has been prescribed. In Montana, separate accounting is required.

[25] Mississippi, Montana, North Carolina, Oregon, Tennessee and Vermont.

[26] Arkansas, Georgia, Mississippi, Missouri, Montana, Virginia and Wisconsin.

[27] It is to be noted that under certain circumstances separate accounting may be permitted, if placed to a judicial test, regardless of a statutory provision to that effect. In such a case, of course, it is necessary for the taxpayer to prove that the formula operates inequitably. This is illustrated in the Hans Rees case, which is discussed at P. 45.

FEDERAL.—In general, it is believed that fractional and empirical methods should be used only as a last resort, as in some instances they tend to spread inequalities on an even basis, whereas such inequalities should be localized and remedied through the proper keeping of accounts. In other instances, they distort or throw profits where they do not belong under actual economic circumstances.

The method of separate accounting, subject to verification, is the preferred method. If this method is unsatisfactory in the case of the business of buying and selling or of producing and selling, the percentage of turnover method is considered more practical as an alternative than the fractional method, because the check on the facts on which it is based can be made within the country wherein the taxable income arises, and there is, furthermore, less likelihood of error in the facts themselves and difficulty in analyzing them. This method may not be technically free from error, but, for the classes of business to which it applies (i. e., industrial and mercantile), it forms a reasonable substitute for fair invoicing and keeping of inventories and for a proper accounting in respect to the related business to which they apply.[28]

INTERNATIONAL.—*Fractional Apportionment Method.*—The status of fractional apportionment is summarized in the Carroll report as follows:[29]

The one country in question which regularly employs the method of fractional apportionment for determining the taxable profits of the local branch or subsidiary of a foreign enterprise is Spain. France may use it when the method of separate accounting fails in imposing the profits tax, and employs it regularly for determining the proportion of the dividends distributed or interest paid by a foreign corporation which is to be subject to the tax on income from securities. This proportion is the ratio of assets in France to total assets, and the term "asset" is broad enough to cover all kinds of real or personal property as well as business activity.

The German administration, also, may compute the income subject to its tax as a fraction of the total net profit of the foreign enterprise, on the basis of factors essential to the production of such income. The German authorities may employ this method even in the case of a foreign corporation with a German subsidiary company when the two are considered to form an economic unit. This method is used rarely in Great Britain and in the United States, and then only in cases where the foreign enterprise has a branch in the country.

Separate Accounting.—"The method of separate accounting is the method generally employed in the United States [for federal income tax], Great Britain, Germany and in France for the commercial profits tax."[30]

Empirical Methods.—The status of empirical methods as well as the various types which are used in certain European countries has been presented in a previous section of the report.[31]

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[28] League of Nations, *Taxation of Foreign and National Enterprises* (Geneva, 1932), P. 250.

[29] League of Nations, *op. cit.*, P. 25 f.

[30] Carroll, M. B., "Observations on Report of the Committee of the National Tax Association on Uniformity and Reciprocity in State Tax Legislation" (1931), *Proceedings*, National Tax Association, P. 333.

[31] See P. 25 f.

CHAPTER III

LEGAL ASPECTS OF THE ALLOCATION PROBLEM

Allocation and the "Commerce Clause"

It has been shown that the allocation problem was caused by the projection of corporate activities beyond state boundaries and the subsequent attempts of the states to tax the income originating from combined intrastate and interstate sources. Any state, in shaping a tax policy that might be extended to interstate activity, had to avoid coming into conflict with the "commerce clause" of the federal constitution.[1] That such constitutional limitations were avoided has been shrewdly stated by Professor Powell: "The subjects not classified as interstate commerce turned out to be lambs with fleece of interstate commerce, and the states found ways to get the fleece while they were held to be dealing only with the lamb."[2]

The allocation problem as it relates to corporate income was first presented to the courts in the so-called "Glue Case"[3] in which it was decided that a tax measured by net profits, part of which may have been derived from interstate commerce, is valid, providing there is no discrimination against interstate commerce.

The facts of this case illustrate the various types of transactions that occur when a concern has a manufacturing plant in one state and selling agencies in other states. The income of the United States Glue Company was derived from (1) the sale to customers within the state of goods delivered from its factory; (2) the sale to customers outside the state of goods delivered from its factory; (3) the sale by the branches in other states of goods which were shipped, before the sale, from the factory to the branches—sale and delivery of the goods were thus consummated at the branch; (4) the sale of goods to customers outside the state by branches without the state, the goods having been purchased by the plaintiff outside the state and shipped to the factory within the state, being then re-shipped to the branches for sale; (5) the sale of goods purchased by plaintiff outside of the state and sold directly to the branches outside the state. The plaintiff made no contention regarding the taxability of income in item (1). The contention that items (4) and (5) were not taxable because they were not

[1] Article I, section 8.

[2] T. R. Powell, "Business Taxes and the Federal Constitution", National Tax Association, *Proceedings* (1925), P. 165.

[3] *United States Glue Company* v. *Oak Creek*, 247 U. S. 321 (1918). The doctrine is well established that a state may tax property which is used in interstate commerce: *Western Union Telegraph Co.* v. *Massachusetts*, 125 U. S. 530 (1888); *Pullman Palace Car Co.* v. *Pennsylvania*, 141 U. S. 18 (1891); *Postal Telegraph Company* v. *Adams*, 155 U. S. 688 (1895); *Adams Express Company* v. *Ohio*, 165 U. S. 194 (1897).

derived from property located or business transacted within the state was upheld by the state courts. The controversy was narrowed to the contention, which was overruled by the Supreme Court, that items (2) and (3) were not taxable because they were derived from interstate commerce. The court quoted from *Peck & Co.* v. *Lowe*[4] to the effect that "the distinction between a direct and an indirect burden by way of tax or duty was developed, and it was shown that an income tax laid generally on net incomes . . . was only an indirect burden." It was the opinion in the Glue Case that "a tax upon the net profits has not the same deterrent effect [as one upon gross receipts], since it does not arise at all unless a gain is shown over and above expenses and losses, and the tax can not be heavy unless the profits are large. Such a tax, when imposed upon net incomes from whatever source arising, is but a method of distributing the cost of government, . . . and if there be no discrimination against interstate commerce, either in the admeasurement of the tax or in the means adopted for enforcing it, it constitutes one of the ordinary and general burdens of government, from which persons and corporations otherwise subject to the jurisdiction of the States are not exempted by the Federal Constitution because they happen to be engaged in commerce among the States."

The principle which was enunciated in the Glue Case is not applicable when a corporation conducts only an interstate business. If there is no intrastate business the state may not tax the net income of the corporation. For example,[5] a New Jersey corporation maintained an office in Massachusetts which served as headquarters for travelling salesmen, the orders being transmitted from Boston to the principle office at Easton, Pennsylvania. Regarding the liability of the corporation to taxation in Massachusetts, the court said: "It must now be regarded as settled that a State may not burden interstate commerce or tax property beyond her borders under the guise of regulating or taxing intrastate business. So, to burden interstate commerce is prohibited by the Commerce Clause; and the Fourteenth Amendment does not permit taxation of property beyond the state's jurisdiction. The amount demanded is unimportant when there is no legitimate basis for the tax."

Legal Aspects of the Problem of Method

Most of the cases relative to the allocation of income among the states have involved the question of method, that is, fractional apportionment versus separate accounting. It will appear from the cases cited in this section that the "due process clause" of the Fourteenth Amendment imposes some limitations on the selection of an allocation fraction. However, the burden rests upon the taxpayer of proving that the fraction is in violation of "due process."

[4] 247 U. S. 165, 38 Sup. Ct. 432.

[5] *Alpha Portland Cement* v. *Massachusetts*, 268 U. S. 203 (1925).

If such proof, the nature of which will appear in the sequel,[6] is furnished, the courts may uphold the use of separate accounting.

FRACTIONAL APPORTIONMENT.—*The Underwood Typewriter Case.*—The question of fractional apportionment was first presented in the case of the Underwood Typewriter Company,[7] a Delaware corporation, which had its main office in New York and did all of its manufacturing in Connecticut. It had branch offices in other states for the sale, lease and repair of typewriters, as well as the sale of supplies, and it had one such branch office in Connecticut. All of the articles which it produced and some of its purchases were stored in Connecticut until shipped direct to branch offices, purchasers or lessees. The profits of this company for the year 1915 were $1,336.586.00, which were derived principally from the sale of tangible personal property. In applying the statutory fraction—the ratio of the fair cash value of real estate and tangible personal property in Connecticut to the total of such property wherever located—it was shown that $629,668.50, or 47 per cent of the profits, were taxable in Connecticut. The company contended that the tax violated the Fourteenth Amendment because it was imposed upon business carried on outside of the state. This objection was based upon the fact that only $42,942.18 of the profits were received in Connecticut, while $1,293,643.95 were received in other states, but the court said:

> This showing wholly fails to sustain the objection. The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other states. . . . The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of apportionment which, for all that appears in this record, reached . . . only the profits earned within the State. The plaintiff's argument on this branch of the case, as stated by the Supreme Court of Errors, carries the burden of showing that 47% of its net income is not reasonably attributable, for purposes of taxation, to the manufacture of products from the sale of which, 80% of its gross earnings was derived after paying manufacturing costs. The corporation has not even attempted to show this; and for aught that appears the percentage of net profits earned in Connecticut may have been much larger than 47%. There is, consequently, nothing in this record to show that the method of apportionment adopted by the state was inherently arbitrary, or that its application to this corporation produced an unreasonable result.

The Gorham Case.—A statutory rule often operates in an arbitrary manner, and particularly if a corporation is engaged in the manufacture of two or more commodities, only one of which is produced or sold within a given state. If the entire net income is taken as the measure of the tax, the taxpayer may claim that income arising from purely local sources within another state is included in the computation and is therefore unconstitutional.

[6] See P. 45.

[7] *Underwood Typewriter Company* v. *Chamberlain*, 254 U. S. 113 (1920).

A case of this nature[8] arose that involved the section of the New York statute providing that foreign corporations, for the privilege of doing business in the state, must pay a franchise tax which is measured by its entire net income. The apportionment of the entire net income is to be made in accordance with the proportion which certain designated classes of tangible and intangible assets held within the state bear to the taxpayers' total assets of these classes. The plaintiff, a silversmith, was a corporation organized in Rhode Island, where it was engaged in manufacturing; two of its shops were maintained and a considerable store of goods, largely samples, were kept in New York. The plaintiff claimed among other things that its return of income to the federal government for the year 1918, which was used as the measure of the tax, included the profits upon its munitions business. This business was localized entirely in Rhode Island and was wholly disconnected from the silverware business. The opinion of the court was:

> Any effort at allocation must be more or less arbitrary and fictitious . . . in a business which is a unity, it is impossible to break up the parts and satisfactorily assign to any piece a corresponding part of the income. Take as an instance the record here. Much of the personal property of the plaintiff in New York consists of sample pieces of silverware kept for display, by which goods elsewhere are sold, some of which never come into New York at all. A foreign customer may see such samples and order from them, but the goods may be shipped from Rhode Island to Pennsylvania or Connecticut. Yet it would be an obvious error not to assign any part of the resulting income to the New York samples. No one could possibly say whether the sale would have been made without them. The case in this aspect presents the not wholly unfamiliar difficulty of trying to apportion quantitatively the effect of a number of factors each of which is an absolute condition to the result. In such a case there is no rational solution which will bear scrutiny, and one must proceed by a more or less rough division not too shocking to preconceived assumptions.

A comparison was made with the Underwood Typewriter case, which involved the manufacture of goods by the taxpayer in Connecticut, the taxing state, but few of them were sold within the state. In the Gorham case the plaintiff argued that the sales in New York should not be segregated entirely to New York because the manufacture took place in Rhode Island. In this connection, the court observed that this was true but that it was impossible to say how far sales made elsewhere were stimulated by the shops or stock in New York. "Any rule must therefore be largely conventional."

"As to munitions . . . they were justified in assuming that the income returned was upon a unitary business, and it was the plaintiff's duty either by a rider on its returns or, by applying for a revision . . . to bring the facts to the attention of the Commission and to demand a separation of the two businesses." This statement is very significant. Once more, as in the Underwood Typewriter case, the burden was placed upon the plaintiff of proving that the apportionment was unreasonable. In both

[8] *The Gorham Manufacturing Company* v. *Travis*, 274 Fed. 975 (1921).

instances, the complainants were unable to furnish proof in support of their contention.

The Bass Ale Case.—The New York fraction was upheld in another case[9] in which a peculiar set of facts were presented. The relator was a British corporation engaged in the brewing and selling of Bass Ale. Its business in New York consisted of the importation and sale of Bass Ale, which was manufactured in England. The case in question involved the amount of the franchise tax for the year begining November 1, 1918.[10] For the taxable period the total net income was $2,185,600.00, although no net income arose from sources within the State of New York. The company contended that the imposition of such a tax would deprive it of property in violation of the due process clause and impose a direct burden upon its foreign commerce. The court held that this was "not a direct tax upon the allocated income of the corporation in a given year, but a tax for the privilege of doing business in one year measured by the allocated income accruing from the business in the preceding year."

The observation was made that the question of constitutionality was largely controlled by the opinion in the Typewriter case, and it was not shown in this instance that the statutory fraction produced an unreasonable result. "The fact that the Company may not have had any net income upon which it was subject to payment of income tax to the Federal Government, obviously does not show that it received no net income from the business which it carried on in New York."[11]

The Kresge Case.—Another complaint against the New York fraction was filed by the S. S. Kresge Company.[12] It was contended that the statutory method should be abandoned in favor of a segregation by the company's own accounting methods, because the base determined by the tax commission was larger than the actual net income derived from plaintiff's property, business and activities within New York; or, in other words, that part of the plaintiff's net income from without the state was subject to taxation in New York. It was brought out that this company was a large corporation owning and operating a chain of between 367 and 435 retail stores in the United States, of which between 39 and 48 were located in the State of New York. A well organized central purchasing department was maintained which operated for the entire system. The purchasing department had also an importing depart-

[9] *People ex rel. Bass, Ratcliffe & Gretton, Ltd.* v. *State Tax Commission*, 133 N. E. 122, 266 U. S. 271 (1924).

[10] The characteristics of the New York franchise tax are that (1) it is measured by entire net income for the preceding year; (2) it is payable whether a profit or loss is shown—in case of loss the taxpayer is subject to a minimum tax; (3) a company is not liable if it discontinues business before November first of any year; (4) it is in lieu of tangible personal property taxes on the corporation.

[11] For other aspects of this case, see P. 21 f.

[12] *S. S. Kresge Company* v. *Bennett*, 51 Fed. (2d) 353 (1931).

ment and a jobbing department, the chief functions of the latter being to operate a warehouse in New York for the entire system. The executive office and purchasing department were located in Detroit. In the computation of the franchise tax that was due for the years beginning November 1, 1927 and 1928, three different methods were followed, namely: (a) the New York statutory fraction for segregating assets, by which the percentage of net income attributable to New York was approximately 9.72% and 8.97% for 1926 and 1927; (b) the ratio between gross sales within the state and total gross sales, which showed the percentages to be 8.40% and 8.93%, respectively; and (c) the accounting procedure of the plaintiff, which showed the amount attributable to New York to be only 6.30% and 6.31%, respectively. The company's accounting procedure was:

> To charge against each individual store the invoice cost of the goods delivered to it by the central organization, together with certain percentages estimated as sufficient to pay the expenses of the central organization. On all goods handled by the importing and jobbing departments, 2 per cent and 5 per cent, respectively, which were added to the invoice cost; and 2 per cent of the gross sales of each store was charged against it for general overhead expenses. Against the gross income from each store was charged not only the invoice cost of the goods and the above percentages, but also the operating expenses of the particular store, and the result was entered on the books of the company as the entire net income from the store.

The percentages charged to the importing and jobbing departments were criticized by the Attorney General because they were merely estimated expenses of the business. The contention was made that:

> It might well be that the service rendered to the New York stores by the central organization should be charged for at a different rate from that applicable to other parts of the system; for instance, the services performed by the executive offices and purchasing department are charged for at the rate of 2 per cent, not on the invoice cost of the goods furnished to the stores, but on the gross sales of the stores. If the New York stores were receiving higher prices for the same goods than stores elsewhere they would be paying a disproportionate part of the expenses of furnishing the goods.

It was also contended that the part of the profit which may have resulted from the functions of storage and purchasing were not completely reflected in the total net profit of the stores within the state which the plaintiff contended constituted the entire net income attributable to New York.

> Since the plaintiff cannot show by the facts before us what was its net income from New York State, but can merely estimate it, we do not think that there is anything before us to sustain the contention that the method of apportionment adopted by the commission was unconstitutional. If the actual net income from the state cannot be demonstrated with reasonable certainty the commission can properly be intrusted with some discretion in determining what method to use in approximating it.

On the question as to whether the facts required a different method from that followed by the Commission, the court said that "these facts were neither proved nor offered to be proved before

the commission. . . . At the hearing upon the application for revision the taxpayer had the burden of proving not only that error existed in the original assessment, but also the amount of the error."

Effect of Decisions Upholding Fractional Apportionment.—The net effect of the decisions in the preceding cases is that any formula will be sustained unless the taxpayer submits convincing evidence and proof that it operates inequitably when applied to his business. A decision such as that in the Kresge case affords little encouragement to the taxpayer that he will be able to prove his contention. However, the following cases, and particularly the Hans Rees case, in which separate accounting was upheld, throw a new light on this question.

SEPARATE ACCOUNTING.—The application of an allocation fraction may result in an "unreasonable" apportionment of income; under such circumstances, the method of separate accounting will be upheld. The courts have not stated specifically what constitutes a "reasonable" or "unreasonable" apportionment. Nevertheless, the judicial attitude is clarified in the Hans Rees case,[13] in which the Supreme Court upheld a segregation and allocation of income by separate accounting methods. The Standard Oil cases are significant because of the rejection of the "unitary theory" as applied to the petroleum industry.

Fisher v. Standard Oil Company.[14]—The business of the appellee in North Dakota consisted of selling at wholesale and retail petroleum products and by-products which were produced and refined outside of the state but were shipped into the state for selling. The appellant asserted that it was not possible to segregate the North Dakota business of the appellee from its other business. The question involved was that of a reassessment which was made for the years 1919–1921, inclusive. The court held that such reassessment was void and it enjoined collection of the amounts on the ground that the tax commission had pursued a method of arriving at appellee's net income within the state not authorized by the statute and in conflict with its express provisions. In determining taxable income it was "freely conceded that the commissioner wholly ignored the value of appellee's property which it uses in the production, manufacture and refining of its products, because it is contended that profits or income arises only from sales and not from production and manufacture. The property of appellee devoted only to sales and distribution in the different States, was also ignored in arriving at the ratio for the purpose of reassessment."

The court held that "for the purpose of allocation . . . there was no occasion for speculation by the commissioner as to the meaning of business within and without the State. The statute carries its own definition for that purpose." It was also held that all property used by the corporation in producing and refining should be included, since profits allocated to outside states accrue partially from manufacture and refining, although the only property within the state was that which was used in the sale and distribution of products. Finally, "we think it cannot be doubted that the products as brought into the State had an easily ascertainable wholesale market price. We think appellee's business within the State is easily separable from its other business by charging it with the wholesale price of products which it sells in North Dakota. That would put it on an equality there with those who sell and do not produce and refine."

[13] See P. 45.

[14] 12 Fed. (2d) 744 (C. C. A. 8th) (1926).

Standard Oil Company of Indiana v. Thoresen.[15]—In this case the taxpayer was a corporation engaged in the producing, refining and distribution of crude oil, although its business in North Dakota was confined solely to the distribution and sale of the refined product to the consumer. The accounting procedure which was followed by the company was such that it could separate the income derived from distribution and sale from that of producing and refining. The plaintiff filed a statement of its business in North Dakota and an apportionment was made, as provided in the statutes, on the basis of the ratio of the property and business within the state to the total of such property and business. On this amount the tax was calculated and paid. However, the tax commissioner made an additional assessment which was based upon the allocation to North Dakota of a portion of the income arising from the business of producing and refining crude oil, although none of this business was carried on within the state. This suit was brought to enjoin the collection of such additional tax. The contention of the state was that the business should be regarded as a unit in the production, transportation, refining and marketing of oil, but this was rejected by the court on the ground that the activities were separable and did not fall within the rule of unity[16] as

[15] 29 Fed. (2d) 708 (C. C. A. 8th) (1928).

[16] A description and history of this as interpreted by the United States Supreme Court is found in the majority and dissenting opinions in *Union Tank Line Company* v. *Wright*, 249 U. S. 275, 39 Sup. Ct. 276 (1919). See also the unit rule, Isaacs, 35 *Yale L. J.* 838 (1926). "According to this rule the entire property of a railroad, telegraph company, or such, was treated as a unit and divided between the states for taxation purposes according to a theoretically representative fraction, such as the railroad trackage within the state over the total trackage of the road. The unit rule was upheld by the Supreme Court in a long line of cases until it seemed firmly and irreversibly established. (*Kentucky Railroad Tax Cases*, 115 U. S. 321, 6 Sup. Ct. 57 (1885); *Western Union Telegraph Company* v. *Massachusetts*, 125 U. S. 530, 8 Sup. Ct. 961 (1888); *Pullman's Palace Car Company* v. *Pennsylvania*, 141 U. S. 18, 11 Sup. Ct. 876 (1891). [This case has been referred to as the foundation of the unit rule—*Cf.* Sherman Baldwin, "State Taxation of Foreign Corporations Engaged in Interstate Commerce" (1924), 33 *Yale Law Journal* 406]; *Adams Express Company* v. *Ohio*, 165 U. S. 194, 17 Sup. Ct. 305 (1897); *American Refrigerator Transit Company* v. *Hall*, 174 U. S. 70, 19 Sup. Ct. 599 (1899). Then in *Union Tank Line Company* v. *Wright*

stated in *Adams Express Company v. Ohio.*[17] The court held that:

On its properties within the state of North Dakota employed in the business of marketing oil, and on the income arising from the doing of that business within the state of North Dakota, it may be there taxed by the state and the tax must be paid. On its business of producing and refining oil it should be taxed only by the state in which this production is found or refining done. In the manufacture or refining of crude oil in different states it must be taxed and pay its taxes within said states; . . . It is conceded to be a very easy matter for the state to determine the market value of refined oils within its borders at any time and place, and on this, having ascertained the selling price, to determine the tax necessary to be paid.

Standard Oil Company of Indiana v. Wisconsin Tax Commission.[18]—The appellant was engaged in producing, refining, transporting and marketing petroleum products and by-products in eleven states. The refining activities were mostly in Indiana, while its property in Wisconsin consisted mainly of tanks and filling stations to meet the local demands. Fifty-four per cent of the oil stored in Wisconsin tank farms was sold within Wisconsin, the remaining forty-six per cent being sold mainly in Minnesota. The company argued that its accounts for Wisconsin were kept separately and revealed the amount of net income that was earned within the state. It claimed that the amount of taxable income was represented in its accounting records by the difference between the expense of doing business in Wisconsin, including a proper allocation of general or overhead expenses and office accounting, and the gross sales within the state. Applying this method it appeared that the tax for 1925, the year in question, amounted to approximately $89,000.00 as compared with $157,000.00 which was the amount of the tax arrived at through the use of the statutory allocation fraction—tangible property, manufacturing costs and sales. The tax commission argued that the entire business was unitary and any separation of the parts was an arbitrary arrangement that would produce inequitable results. The contention was made that selling facilities in Wisconsin increased the company's manufacturing profits in other states, and therefore a portion of the manufacturing profits were properly attributable to Wisconsin. On this point the court held that if this were true then likewise the converse must be true that the sales operations for Wisconsin benefit by the manufacturing operations of the plaintiff corporation in other states. "We regard as unsound the argument submitted to sustain the Commission's position in this case." To carry it

protest was made against calculation by the trackage fraction of a Georgia property tax on tank cars used in and out of the state. The taxpayer produced statistics to show that the average number of its cars in the state per day was considerably lower than the theoretical average computed by the tax fraction. The Supreme Court, won over by the numerical disparity, reversed the tax in spite of a strong dissent joined in by three of the justices, which spoke of the evils of leaving tax ascertainment, 'wholly within the breast of the taxpayer.'" 40 *Yale Law Jour.* 1279 (1931).

[17] 165 U. S. 194, (1896).

[18] 197 Wis. 630, 223 N. W. 85 (1929).

further, "if it should appear that the manufacturing operations were conducted at a loss in other states, would it be claimed that some part of that loss might properly be charged to sales operations in the state of Wisconsin to diminish the Wisconsin income? We think not. There are some operations which from their very nature produce an income which cannot be properly allocated by separate accounting methods, most of which are the telegraph, telephone and express companies. They stand ready to serve whoever may apply for service, and the entire operation constitutes a unit of service. That is not the case with the manufacturing and sales business, particularly so where the accounts are so kept as to be readily separable." The decision in the Underwood Typewriter case was mentioned as not being inconsistent with the conclusion here since "there was no separation on the basis of market value between the operations of the maufacturing department and the sales department, as there is in this case. We perceive no reason why under the facts in this case, the profits derived from the sales operations should not be ascertained so far as the plaintiff is concerned as they would be if the sales operations were conducted by a separate corporate entity."

The Hans Rees Case.—The legal status of separate accounting was firmly established in the case of *Hans Rees' Sons v. State of North Carolina.*[19] This involved a New York corporation which was engaged in the business of tanning, manufacturing and selling of belting and other heavy leather. Its tannery located at Asheville, North Carolina, was used as a manufacturing plant and supply house which sometimes shipped direct to customers. Its sales office was located in New York, from which sales were made throughout the United States and in Canada and Europe, although some sales were made in North Carolina. Between forty and fifty per cent of the output of the Asheville plant was shipped from Asheville to New York; the other sixty per cent was shipped directly on orders from New York. The income of the business was derived from three sources: (a) buying profit resulting from unusual skill in taking advantage of price fluctuation in the hide market—"a comparison of the average cost of appellant's hides with the average cost of hides of similar quality sold in the market during the year gave an approximate indication of profit or loss from these transactions which were not conducted in North Carolina"; (b) manufacturing profit, which was represented by the difference between the cost of tanning done by contract and the actual cost thereof when done by the petitioner at its own plant in Asheville—this profit was credited to operations in North Carolina; (c) selling profit resulting from the method of cutting leather into small parts so as to meet the needs of a given customer—this profit was not attributable to operations in North Carolina.

[19] 199 N. C. 42, 153 S. E. 850, 51 Sup. Ct. 385 (1931).

In splitting the gross profits into the three sources listed above the starting point was the existing differentiation between wholesale and retail business, the profits from the latter being attributable entirely to New York. The profits from the wholesale business were partly divisible between the manufacturing in Asheville and the selling in New York, although the company's accountants made no attempt at segregation so that the entire wholesale profit was credited to manufacturing and allocated to North Carolina. The principal question related to the amount of taxes for the years 1923–1926, inclusive. The North Carolina statute provided for an allocation of income on the basis of location of real estate and tangible personal property, and on that basis there was apportionable to that state the following approximate percentages of total net income for the four years: 83%, 85%, 66% and 85%, or an average of eighty per cent. From the accounting records of the company it was shown that only seventeen per cent of its total net income was attributable to North Carolina. The Supreme Court of North Carolina, in upholding the statutory fraction, relied upon the decisions in the Underwood Typewriter[20] and Bass Ale[21] cases, and sought to justify its view upon the grounds that:

> The fallacy of this conclusion [that is the appellant's contention that application of statute had been shown to be unreasonable and arbitrary and hence repugnant to the Federal Constitution] lies in the fact that the petitioner undertakes to split into independent sources, income which the record discloses was created and produced by a single business enterprise. . . . Petitioner was not exclusively a hide dealer or a mere tanner or a leather salesman. It was a manufacturer and seller of leather goods, involving the purchase of raw material and the working up of that raw material into acceptable commercial forms, for the ultimate purpose of selling . . . for a profit. Therefore, the buying, manufacturing and selling were component parts of a single unit. The property in North Carolina is the hub from which the spokes of the entire wheel radiate to the outer rim.

However, Chief Justice Hughes in stating the opinion of the United States Supreme Court, said:

> We are unable to agree with this view. The evidence which was found to be lacking in the Underwood and Bass Cases, is present here. These decisions are not authority for the conclusion that, where a corporation manufactures in one state and sells in another, the net profits of the entire transaction, as a unitary enterprise, may be attributed, regardless of evidence, to either state . . . The difficulty with the evidence offered in the Underwood Case was that it failed to establish that the amount of net income with which the corporation was charged in Connecticut under the method adopted was not reasonably attributable to the processes conducted within the borders of that state; and in the Bass case the court found a similar defect in proof with respect to the transactions in New York. Undoubtedly the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business and all the factors in that enterprise are essential to the realization of profits. The difficulty of making an exact apportionment is apparent, and hence, when the state has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered

[20] Note 7, *supra*.
[21] Note 9, *supra*.

> of an unreasonable and arbitrary application . . . the statutory method, as applied to the appellant's business for the years in question operated unreasonably and arbitrarily, in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted by the appellant in that state.

It should be noted that although the method of separate accounting was upheld in this case, nevertheless great emphasis was placed upon the fact that the statutory fraction was clearly unreasonable. This is evident from that section of the opinion in which the court said:

> For the present purpose, in determining the validity of the statutory method as applied to the appellant, it is not necessary to review the evidence in detail, or to determine as a matter of fact the precise part of the income which should be regarded as attributable to the business conducted in North Carolina. It is sufficient to say that, in any aspect of the evidence, and upon the assumption made by the state court with respect to the facts shown, the statutory method was unreasonable.

The Corporate Contract As An Instrument for Evading Allocation Requirements

In presenting the legal phase of the allocation problem some consideration should be extended to the matter of tax evasion, and especially since several such cases have been brought to the attention of the courts. The principal means of evasion, as brought out in the cases, is the manipulation of contracts between two separate, but related corporations.[22] The purpose of such contracts is to divert, or "siphon" income from one corporation to an affiliated corporation in another taxing jurisdiction. There are two main incentives to evasion, *viz:* (1) the alleged unfairness of certain allocation fractions as, for example, the Connecticut formula, and (2) the possibility of diverting income into one or several of the twenty-seven, non-income-taxing states. Because of the possibility of diverting income into a non-income-taxing state it is frequently difficult to obtain a full report of net income from a domestic subsidiary or a branch of a foreign corporation. A corporation may be organized and operated in such a manner as to show only a small profit or even a loss when actually it is operated at a substantial profit. Several of the states make some statutory provision for empowering the tax commission to investigate the facts and make a realloction of income, if it can be proven that there was an attempt to defraud the state.[23] The fol-

[22] See Roswell Magill, "Allocation of Income by Corporate Contract," (1931) 6 *Harv. L. Rev.* 935.

[23] Most of the statutes are similar to the regulation provided in the Wisconsin statutes to the effect that "when any corporation liable to taxation under this act conducts its business in such a manner as either directly or indirectly to benefit the members or stockholders thereof or any persons interested in such business, by selling its products or the goods or commodities in which it deals at less than the fair price which might be obtained therefor, or where a corporation, a substantial portion of whose capital stock is owned either directly or indirectly by another corporation, acquires and disposes of

lowing illustrations represent the most important cases that have come before the court.

BUICK MOTOR CO. v. CITY OF MILWAUKEE.[24]—The Buick Motor Company, a Michigan corporation, was engaged in the retail distribution of automobiles through a branch with headquarters in Milwaukee. The entire capital stock of this corporation was owned by the General Motors Company, a Delaware corporation, which operated manufacturing plants in Michigan. According to a contract made in 1917 the Buick Motor Company agreed to buy the entire output of the automobiles and accessories of the General Motors 'Buick' factory at Flint, Michigan, upon a basis resulting in an annual net profit of only $2,500 to the Buick Motor Company.

The question presented to the Circuit Court of Appeals involved the validity of a reassessment under authority granted by the Wisconsin Legislature in 1925 for 'back taxes' for the years 1917–25, inclusive. During these years the annual sales of cars and accessories by the appellant ranged from a minimum of $89,000,000 to a maximum of $231,000,000, while the annual sales of the Wisconsin branch were from $2,454,000 to $6,800,000. The automobiles and accessories sold by the Wisconsin branch were billed to it by the appellant at about the same price as was charged to independent distributors. In 1917 the income returned by the appellant for taxation in Wisconsin amounted to $5,018.42, but it later contended that its income was only $2,500 that year and for several years thereafter. For 1919 the tax commission added approximately $80,000 as additional income, which had been withheld by the appellant as a reserve for dealers' rebates. According to the calculations of the Commission, this amount represented the Wisconsin proportion of the aggregate income of $1,419,290.

In 1920 the Commission expressed its disapproval of the appellant's general plan for the return of its income, and in 1921 initiated the general practice of treating the Wisconsin branch as though it were an independent jobber or distributor of Buick products; until 1925 the appellant presumably made its return of income on this basis. In 1926 the Commission made its own audit of the appellant's accounts and concluded that the income returns had not truly reflected the income and a reassessment was ordered which increased the taxes payable for the period of 1917–25 by approximately $226,000. The method followed by the Commission in calculating the taxable income was to compute the Wisconsin gross income "on the basis of selling price less the cost, as if the Milwaukee Branch were in fact an independent distributor. This appeal presents no question of theoretical computation of income. In order to arrive at the gross income of the Milwaukee branch, the Tax Commission used actual sales to dealers by this branch, and actual prices which independent distributors were being charged for cars; and all expenses which an independent dealer would have to pay, have been allowed if the expenditure was incurred either by the appellant or by its parent in appellant's behalf." This reassessment was upheld by the district court and in turn affirmed by the Circuit Court of Appeals.

Regarding the validity of the contract the circuit court observed that:

> Whether the contract, as between the contracting parties, is upon its face fraudulent, does not concern the state in the matter of its taxes upon income derived from business transacted within its limits. Whatever other purpose such a contract might have, the conclusion seems quite irresistible that one of its objects was to transfer the income arising from the business of such states as then had, or might thereafter enact, an income tax law, so that the income would not be taxable in the state where earned . . . By turning over to General Motors the remittances for sales made by appellant's Wisconsin branch, the profits which appellant earned on its Wisconsin business were diverted to appellant's one stock owner—General Motors. While appellant carried on this vast business under an arrangement with General Motors whereby the profits realized at once passed to General Motors, the profits constituted taxable income in Wisconsin ere they passed to the single beneficial owner of the capital stock.

THE PALMOLIVE CO. v. CONWAY.[25]—This case presents a very complicated corporate structure. The Palmolive Company, which will be designated as the Wisconsin Company, had been engaged in the manufacture and sale of soap in Milwaukee since 1894. In 1923 its officers organized as a Delaware corporation the Eastern Operating Company, which later became the Palmolive-Peet Colgate Company, referred to here as the parent company. In the same year there was organized in Delaware the Western Operating Company, which retained this name during the period under consideration, 1924–26, but in 1927 it became the Palmolive Company (of Delaware). This company acquired all of the outstanding capital stock of the Wisconsin Company following its dissolution, becoming thereby liable for the alleged unpaid additional income taxes, and is, therefore, designated as the plaintiff company.

Upon incorporation the parent company acquired all of the capital stock of the Wisconsin Company. It also purchased all of the real estate and tangible personal property located outside the state, accounts receivable due from parties outside the state, and intangibles consisting of trade names, trade secrets and good will, paying for the same by delivering to the Wisconsin Company a certain proportion of the Wisconsin Company's capital stock,

the products of the corporation so owning a substantial portion of its stock in such a manner as to create a loss or improper net income, the commission may determine the amount of taxable income of such corporation for the calendar or fiscal year, having due regard to the reasonable profits which but for such arrangement or understanding might or could have been obtained from dealing in such products, goods or commodities." Wis *Stat.* 1925, ch. 71.25, sec (1). See also: Conn. *Gen. Stat.*, sec. 1098 (1930); N. Y. *Tax Law.* Art. 9A Sec. 211 (10);

[24] 43 Fed. (2d) 385, 48 Fed. (2d) 801 (C. C. A. 7th) (1931).

[25] 43 Fed. (2d) 226 (1930).

which then became treasury stock of the Wisconsin Company. The remainder of the capital stock the parent company then sold to the plaintiff company in exchange for the entire capital stock of plaintiff and certain advances, thus creating a sort of grand-parent relationship. Then the plaintiff company bought the manufacturing plant and equipment of the Wisconsin Company located at Milwaukee, paying for the same with a part of the capital stock of said Wisconsin Company, which it had received from the parent company. This stock likewise became treasury stock of the Wisconsin Company, so that the only outstanding capital stock of the Wisconsin Company was a portion remaining in the hands of the plaintiff company.

The upshot of the reorganization was that the parent company became the owner of property transferred from the Wisconsin Company, consisting of tangible property outside Wisconsin and the intangibles, and of all the capital stock of the plaintiff. The plaintiff acquired ownership of the Milwaukee plant and equipment and of all the capital stock of the Wisconsin Company. The Wisconsin Company in turn continued as owner of the Milwaukee inventory and accounts receivable relating to Wisconsin business. The Wisconsin Company contracted to sell its entire output of Palmolive soap, except such as it might sell in Wisconsin, to the parent company at factory cost plus three per cent, which was changed later to factory cost plus six per cent. All purchases of materials used by the Wisconsin Company were made by the parent company, and in addition it supervised the manufacturing activities of the former. On this contractural basis the Wisconsin Company "in 1924 reported an income of $298,000, in 1925 $273,000, and in 1926 $341,000. Plaintiff reported on the basis of its rental receipts from the Wisconsin Company, less interest paid to the parent company, and reported net income in 1924 of $17,950, in 1925 a deficit of $90,911, and in 1926 a deficit of $101,352. (After 1924 an interest charge of five per cent was made on an open account amounting to more than $4,000,000, which wiped out the plaintiff's income from rentals and created a deficit). The tax commission allocated certain of the profits of the parent company and of the Buckingham Agency[26] to these two companies, fixing the taxable income of both of them for 1924 at $1,297,967, or an increase of $1,175,108, and for 1926 at $1,367,879, or an increase of $1,127,446. It is the assessments upon this alleged additional income that plaintiff now seeks to enjoin."

The question presented was "whether, with the same business in Wisconsin as before, the corporation has by its contracts so manipu-

[26] This agency was organized in another state for the purpose of placing advertising of the parent company with advertising houses and collecting commissions thereon. Its activities had no connection with manufacturing. No part of its income was earned directly or indirectly within Wisconsin, and thus was not taxable within the state. The court held that the injunction should be allowed for such part of the additional assessments as were due to the allocation of the income of this agency to the plaintiff and to the Wisconsin Company.

lated its organization and contracts and relations to cover up the true income attributable to Wisconsin property and business; whether the court may go behind the contracts of the correlated corporations, or whether it is bound by the same."

In making its computation of taxable income the decision shows that these facts were brought to light by the tax commission:

> The Wisconsin Company, for the period of 1924, 1925 and 1926, received an average price per gross for the product sold parent company of $3.52 and for the product sold in the trade in Wisconsin of $9.24, while the parent company received from the trade for its soap manufactured by Wisconsin company an average price of $9.14. This resulted in an average gross profit to Wisconsin Company of 17c per gross on the goods sold parent company, and of $5.78 on the goods sold direct to Wisconsin trade, while the parent company in the same years realized upon the soap manufactured by Wisconsin Company for it $5.61 per gross. Through its operations during the period of 1921, 1922 and 1923 the Wisconsin Company sold on an average per year $19,519,531, with an average gross profit of $10,305,573, or over 50 per cent of the sales. For the years 1924, 1925 and 1926 the Wisconsin Company, with a product of some slightly greater cost, had total average sales, including Wisconsin sales, of $11,711,975, and an average gross profit therefrom of $936,483, or only about 9 per cent of the sales. The gross profit in the three latter years was less than 10 per cent of the gross profits for the three preceding years, though the volume of articles sold was greater. Obviously, this reduction of over 90 per cent in gross profit and of almost 50 per cent in total sales was due entirely to the fact that under its contract, in the latter years, it sold substantially all its product for factory cost plus 3 per cent or 6 per cent to the parent company, which then disposed of same to the trade at an average gross profit of about 50 per cent, which in the former years had been realized by Wisconsin Company.
>
> In 1921, 1922 and 1923 substantially 90 per cent of the profits were found to have accrued in Wisconsin, in the years 1924, 1925 and 1926 the apportionment to Wisconsin was only 55.28 per cent. The increased apportionment of 33 per cent to the territory outside of Chicago was found to be due to the removal of the activities other than manufacture out of the state. In 1921, 1922 and 1923 the average annual Wisconsin income was about $1,800,000, and the income earned out of the state just over $225,000. In the years 1924, 1925 and 1926, according to the commission's allocations, the average annual Wisconsin income was $1,341,274 and the average annual outside income $1,321,053. In other words, the tax commission found that Wisconsin Company and plaintiff had through entirely legal means removed from the state annual income of $1,321,000, or six times as much as had previously been earned without the state, and that, though the total profits from manufacture and sale had increased, the total income earned within the state was only about two-thirds what it had been. It reduced earned Wisconsin income to two-thirds of its former amount, and increased the income out of the state six times.

Regarding the plaintiff's contention that the factory cost plus percentage contract was fair and equitable, the court observed that other companies following this practice did not exhaust their entire productive capacities in the process, but simply made use of their additional capacities in this manner as a filler or supplement to their regular production, thus furnishing some profit from sources which might otherwise be idle. "There is in the record an eloquent silence as to any manufacturer who has built or bought a factory for the purpose of devoting it entirely to cost plus production."

These and many other similar facts led the court to conclude that "the contract of factory cost plus percentage manufacture and sale to the parent company constituted a fraud upon the income tax laws of Wisconsin. . . . It is apparent that the operations of the plaintiff and the Wisconsin Company were subject to the jurisdiction of the state of Wisconsin, and there is nothing improper or unconstitutional in the manner in which the tax commission attempted to reach and did reach their proper income."

PEOPLE EX REL. STUDEBAKER CORPORATION OF AMERICA v. GILCHRIST.[27]—This case represents a different type of evasion from that which was involved in the two preceding cases. The litigation originated out of a provision of the New York Tax Law[28] relative to the requirement for a consolidated return. Such a return was required from an owning corporation, that is the parent, when it was engaged in business within the state. There was no provision, however, for a consolidated return by the corporation that was owned, or the subsidiary, until the 1925 act corrected such omission. Despite the fact that it seemed to be a case of tax evasion as is indicated below, the subsidiary, through a legal technicality, was able to avoid the allocation requirements.

The Studebaker Corporation of America was a New Jersey corporation engaged in the selling of automobiles and accessories in New York and elsewhere. All of its capital stock was owned by a foreign corporation, the Studebaker Corporation, which manufactured automobiles and accessories in Indiana and Michigan, and sold them to subsidiaries similar to this one, carrying on business in other districts. In 1920 an arrangement was made in which the parent corporation agreed to sell its motor vehicles and accessories to the Studebaker Corporation of America at the list price which was fixed by the manufacturer, less 25% on cars and 33⅓% discount on parts. In 1920 the distributor showed a loss of $449,-133.14, a condition peculiar to all the other subsidiaries except the Studebaker Sales Corporation of Ohio; while the parent in the same year made a net profit of $11,434,954.41 from all of its operations, including both manufacture and sale. However, the distributor's loss was taken over by the parent corporation at the end of the year, and apparently the same thing had been done in previous years as the subsidiary at the end of 1920 was indebted to the parent for more than $9,000,000.00. In 1921 the subsidiary apparently had a loss of $2,168,178.63. Likewise losses were shown by all the other subsidiaries except the Studebaker Sales Corporation of Ohio, while the profits of the parent were $13,684,952.73.

On the basis of these losses the corporation would have been liable for the minimum tax in the amount of $12.14 in 1921 and $15.91 for 1922. The tax commission imposed a tax on the basis of the consolidated return for the parent and subsidiaries as reported to the federal government; computed in this manner the

27 244 N. Y. 114 (1926).
28 Art. 9A, Sec. 211, Subd. 9, as of July 1, 1922.

tax amounted to $9,398.66 for 1921 and $11,936.24 for 1922. The court, however, held that the tax had been improperly assessed according to the provisions of subd. 9, of section 211 of the Tax Law as of July 1, 1922. It was stated in the decision that "the tax has been laid upon the theory that the profit to the agent in order to be fair and reasonable must absorb the entire profit to the principal from the business of the agency. . . . The business transacted by the principal included process of manufacture carried on in Michigan and Indiana, a process which was anterior . . . to any service by the agent."

As to the test of the legitimacy of the contract, we note that the "taxing officers of the state may disregard the subsidiary altogether as a bookkeeping device when there is evidence to justify the finding that it is a device and nothing more. . . . Before 'the corporation persona' may be ignored, the evidence must show that 'the subsidiary is not left with any autonomy' (*Procter & Gamble Co.* v. *Newton*, 289 Fed. Rep. 1013), and that the parent though in form speaking and acting through another, is operating the business directly for itself."

The dissenting opinion of Justice Crane is in harmony with the present attitude of the courts, in which he pointed out, regarding the method followed by the tax commission in computing the amount of the tax, that such method might have been inaccurate and relator had an opportunity to furnish information showing what would have been a fair profit, but did not. It was for the relator to show whether or not there was an actual or fictitious loss.

Conclusion

The net effect of the decisions relating to allocation methods is that any rule of fractional apportionment will be upheld if it appears to be reasonable, and the burden of showing that any rule is unreasonable rests upon the complaining taxpayer. Despite the decisions in the Standard Oil cases, it seemed uncertain whether the taxpayer, that is a mercantile and manufacturing corporation, would be able to prove a contention of "unreasonableness" and thereby receive judicial sanction of separate accounting. This uncertainty was eliminated by the Supreme Court in the Hans Rees case. For this reason, the Hans Rees case marks a turning point in the trend of decisions. However, when viewed from another standpoint, it seems that the attorneys for the Hans Rees Company were guided by direct precedent, the source of which was in a section of the opinion delivered in the Typewriter case stating that "there is...... nothing in this record to show that the method of apportionment adopted by the state was inherently arbitrary or that its application to this corporation produced an unreasonable result."

The decisions do not answer the question as to what is an "unreasonable" or "arbitrary" apportionment and it is doubtful if a precise answer is possible at present. "Reasonable" is a word

admitting of very wide latitude in interpretation. The difficulties in giving a precise answer to the question of what constitutes a reasonable ratio have been cogently stated by Professor Powell:

> Supreme Court justices are not specialists in economics and accounting and they have many other things to do. The Constitution offers them no guide about ratios and bases and allocations. It merely offers them an opportunity to pass judgment. The sources of judgment are sources outside the Constitution and outside the common law. The most that a court can do is to spot something clearly bad, and much that is clearly questionable is not clearly bad. Judicial condonations of modes of allocation should, therefore, not be taken as tokens that these modes are the best that can be devised. Doubtless there is no such animal as an intrinsically good ratio. The best that can be hoped for is a good stab at a good ratio.[29]

It is not contended, in this report, that the burden rests upon the Supreme Court of differentiating clearly between "reasonable" and "unreasonable" practices. The real burden rests upon the taxpayer to file complaint against the allocation fractions of several states and thus raise the question of non-uniformity and double taxation. When this is done the Supreme Court will have the material for making a contribution to the settlement of the allocation problem.

[29] T. R. Powell, "Business Taxes and the Federal Constitution," National Tax Association, *Proceedings*, (1925) P. 184.

PART II

PRESENT PRACTICES IN THE UNITED STATES

CHAPTER IV

SYSTEMS OF FRACTIONAL APPORTIONMENT

It is the purpose in this chapter to describe the various allocation systems of the income-tax states, with the exception of New York, Massachusetts and Wisconsin, which are considered somewhat in detail in the next chapter. For comparative purposes, the method of the federal government is included in this section, although it uses a fractional apportionment very infrequently. It was deemed advisable also to include a brief explanation of the model allocation proposal, which was made by the Committee of the National Tax Association in 1922, reserving a discussion of the theoretical aspects of this plan for another section of the report.[1]

In the individualistic attempts of the states to tax the income arising out of interstate corporate activities, a haphazard allocation structure has been erected. Uniformity is conspicuous by its absence. The systems are so diverse that classification for comparative purposes is difficult. Even when the same factors are used by several states, it usually happens that different weights are attached to them with the result that little similarity exists. The following classification serves as a general basis for differentiation, although there are wide differences within the groups.

Allocation Systems Based on a Single Factor

The most arbitrary method is represented in the use of a single factor or ratio as a basis of allocation. There are several criteria of business activity, such as manufacturing, buying, warehousing and selling, that may be used in making a fractional apportionment of income. Obviously, the use of a single allocation factor, in determining the proportion of income that is taxable within a given state, may be an inadequate reflection of the amount of business actually conducted therein. The amount of income arising out of business carried on in several states may be affected by all of the business activities jointly, in which event no single factor will suffice in making a proper allocation.

PROPERTY—*Connecticut*.—In Connecticut, the allocation formula, for corporations engaged in the manufacture or sale of real or tangible personal property, is based on the ratio which real estate and tangible personal property located within the state bears to the total of such property wherever located.[2] The fraction is applicable to both foreign and domestic corporations. Tangible property con-

[1] See P. 110 ff.

[2] *G. S.*, Revision of 1930, Ch. 74, Sec. 1327. All other business corporations use the gross receipt ratio. North Carolina used a similar allocation method for several years, but a new method was adopted in 1931.

stitutes an important and perhaps essential measure for determining the situs of income, under the fractional scheme of allocation, but when used exclusively it can hardly be considered as an adequate criterion for distributing taxable income. The implications of this allocation device are indicated in the Underwood Typewriter case.[3] In this case, the company showed that eighty per cent of its gross earnings were derived from the sale of manufactured products outside the state and out of a total of $1,337,000 net profits, only $43,000 were received in Connecticut. Nevertheless, the company was taxed on forty-seven per cent of its net income because forty-seven per cent of its real estate and tangible personal property was located within the state.

SALES AND GROSS RECEIPTS.—It will be observed in the table in the Appendix that all of the states use the item of sales either as a principal or as an alternative allocation ratio. The function of selling should be represented in an allocation fraction, but many taxation inequities arise if the sales factor is used exclusively. If a corporation manufactures all of its goods in Connecticut and sells them in a state which allocates on the basis of sales, as in Tennessee, it will be subject to taxation on two hundred per cent of its income.

Tennessee.—Taxable income is allocated to Tennessee according to the ratio which gross sales within the state bear to total gross sales.[4] The fraction may be applied to both foreign and domestic corporations. A combination of the Connecticut and Tennessee formulae, in the case of a corporation operating in the two states, is an effective illustration of the inequities of non-uniform practices. However, the fractions are not always applied rigidly and a policy of "equitable relaxation" is frequently followed in Tennessee.

Montana.—The statutes[5] provide that income shall be allocated by the method of separate accounting rather than by an arbitrary allocation device. Nevertheless, in practice, an apportionment is made of the business expenses which cannot be specifically allocated. Such an apportionment is made according to the ratio which gross income in Montana bears to total gross income.

Mississippi.—The allocation fraction for trading corporations represents the ratio of the net cost of sales in Mississippi to the total net cost of sales. It is provided, also, that the turnover, as

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[3] *Underwood Typewriter Company* v. *Chamberlain*, 254 U. S. 113. Discussed at P. 38.

[4] *L.* 1923, c. 21, sec. 1, as amended by *L.* 1927, c. 44; instructions contained in Form ET-100 for making income tax return. Chap. 21, *Public Acts*, Second Extraordinary Session, 1931.

[5] *R. C.* Sec. 2298, c. 179.

measured by the cost of sales, must be shown.[6] Foreign corporations, only, are required to use the allocation fraction.[7]

South Carolina.—The allocation fraction is applicable only to foreign corporations,[8] which are required to use one of three methods: (1) foreign corporations which manufacture within the state are required to make an allocation on the basis of the property ratio; (2) the gross sales ratio is used by corporations which are engaged in buying or selling within the state, and which have no property therein; (3) all other corporations use an average of the two ratios.[9]

Missouri.—Missouri has a unique fraction, which is applicable to foreign and domestic corporations. It is provided that the "amount of sales or transactions wholly within this state shall be added to one-half the amount of sales or transactions partly within and partly without this state, and this total shall be divided by the total sales or transactions everywhere to determine the proportion of such total income to be used to arrive at the amount of the tax."[10]

Evidently, the inclusion of one-half of the sales, partly within and without the state, in the numerator of the fraction is an addition for "good measure" in favor of the state, inasmuch as this increases the proportion of net income which is taxable in Missouri. It will be observed in the table of the Appendix that the numerator of the allocation fraction of other states includes only the sales, property or other factors within the state, while the denominator consists of the total of such factors within and without the state.

Arkansas.—Trading or mercantile corporations are required to allocate taxable income to the state according to the ratio which gross sales within Arkansas bear to total gross sales.[11] The use of the arbitrary method is required of foreign corporations only.

Combination Fractions

PROPERTY AND GROSS RECEIPTS.—*Virginia.*—The allocation method which is followed in Virginia represents an intermediate

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[6] *G. L.* 1924, c. 132, Sec. 15 (Code 1927, Sec. 5663). Return IT, Form 301-W-F, Revised. *Code 1930*, C. 124.

Manufacturing corporations make an allocation on the basis of the average ratio of (1) cost value of capital assets within and without Mississippi, and (2) direct and indirect expenditures for labor within and without the state.

[7] Domestic corporations may use the method of separate accounting. However, no credit is allowed for income taxes paid by domestic corporations which operate in other states.

[8] The tax on domestic corporations is measured by entire net income with a deduction allowed for net income from a regular business outside the state.

[9] *Income Tax Act* of 1926, Sec's. 3, 15; Acts 1927, Act 1; *Acts 1930, Acts* 803, 834.

[10] Income Tax Regulations 1931, P. 12. *R. S.* 1929, Art. XX.

[11] Act 118 of 1929, Sec. 15 (3a); Regulations 7, Art. 362, 364. Manufacturing corporations use a fraction which represents the ratio of production costs incurred within the state to the total cost of production.

device between the extremely arbitrary method of a single ratio for allocation and the combination fractions which are described in the remainder of this section.

Instead of alternative fractions, based either on property or sales, the Virginia method is based on a combination of these two items. The fraction is applicable to both foreign and domestic corporations; it represents an average of the ratios of (1) real estate and other physical assets within the state to the total of such property and (2) gross receipts within the state to total gross receipts.[12]

PROPERTY, SALES AND PAYROLL.—The allocation fraction, in five states[13] is based on a combination of property, gross receipts or sales and payroll, each of which are weighted at one-third. The fraction is applicable to both foreign and domestic corporations. The introduction of a third, or balancing factor for the property and sales ratios is significant and should result in a more equitable distribution of the income base among the taxing states than is possible when only a single ratio is used. However, there are many who contend that the use of the payroll factor simply adds a greater weight to manufacturing than to selling and results in the manufacturing or property ratio being weighted at two-thirds in the fraction.

SEGREGATION OF ASSETS.—*New York*.—The New York allocation fraction, which is applicable to both foreign and domestic corporations, is based on the so-called "segregation of assets" device. The entire net income of mercantile and manufacturing corporations is apportioned to the state according to an average of the proportions of certain assets within the state to the total of such assets wherever located.[14]

Vermont.—The franchise tax law of Vermont, which became effective December 31, 1931, requires the return of information of such a nature as to indicate that its method of allocation will be

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12 *Code 1924*, *Supp.* 1928, C. 6, Sec's. 52–54.

13 Massachusetts, *General Laws*, C. 63, Sec. 38; California, *Stats.* 1929 C. 13, Sec. 10—Specific formula contained in Form 105 for Corporation Franchise Tax Return; Idaho, *Laws*, Extraordinary Session 1931, Ch. 2. Sec. 19; Utah, *L. 1931*, C. 39, Sec. 23; Oregon, *L. 1929*, C. 427, Sec. 7—Excise Tax Law Regulations 1929, p. 19 f. See chapter five for other aspects of the Massachusetts practice.

14 The following assets are subject to segregation: (a) average monthly value of real and tangible personal property; (b) average monthly value of bills and accounts receivable arising from (1) personal property sold by the corporation from merchandise manufactured by it within and without the state, (2) the purchase or sale of personal property, and (3) services performed by any officer or agent of the corporation; and (c) average value of stocks of other corporations owned by the corporation. (Such stocks are allocated to the state on the basis of the location of the physical property representing such share stock.) *Tax Law*, Art. 9-A, Sec. 214.

essentially the same as that of New York.[15] The Commissioner of Taxes is empowered to formulate rules and regulations for the allocation of net income.

PROPERTY, SALES AND MANUFACTURING COSTS.—*Wisconsin*.—The taxable income of foreign and domestic corporations is apportioned to Wisconsin on the basis of an arithmetical average of the following ratios: (a) real estate and tangible personal property, (b) cost of manufacturing, which includes costs of goods and materials, wages and salaries, and "overhead," and (c) sales.[16] This method is explained and discussed at some length in chapter six.

Washington.—In November, 1932, the State of Washington adopted a corporation income tax which became effective December 8, 1932.[17] From the basic features of the act, it seems quite evident that the Wisconsin Statute served as a model.[18] The allocation provisions are practically the same as those in the Wisconsin law so that a listing of the allocation factors is unnecessary.

North Carolina.—In 1921, North Carolina adopted a corporation income tax, under which the taxable income of manufacturing corporations was to be apportioned to the state on the basis of tangible property within and without the state. This method is followed by Connecticut at present. However, the practice was changed by the 1931 law which provides two types of allocation fractions to be applicable to foreign corporations only.[19] In the case of a manufacturing corporation, the entire net income shall be apportioned on the basis of the ratio obtained by taking the arithmetical average of the following ratios: (1) fair cash value of real estate and tangible personal property within and without the state and (2) the cost of manufacturing within and without the state, such cost being measured by cost of goods and materials, payroll and "overhead." If the company is engaged principally in "selling, distributing, dealing in or use of tangible personal property" within the state, the entire net income shall be apportioned on the basis of the average of the following ratios: (1) fair cash value of real estate and tangible personal property within and without the state and (2) total sales within and without the state.[20]

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15 General Laws relating to Income Taxes, *Acts of 1931*, Part II, Sec. 9. The same items are specified as in Note 14, *supra*, with the exception of payment for "services performed by any officer or agent of the corporation."

The first returns were not due under the act until April 15, 1932.

16 *Stats.* 1929, Chap. 71.02 (3) (d).

17 *Initiative Measure*, No. 69. It is applicable to all income earned in the calendar year 1932.

18 For a summary of the differences between the two acts, see Commerce Clearing House, *State and Local Tax Service, Washington*, (1932) p. 1245.

19 Domestic corporations are taxed on their entire net income, with an allowable credit for income taxes paid in any other state.

20 *Revenue and Machinery Acts*, Session 1931, Art. IV, Sec. 311.

PROPERTY AND BUSINESS.—*North Dakota.*—North Dakota, in 1923, was the first of the states to adopt an allocation method based on a combination of tangible property and business, each to be weighted at fifty per cent.[21] The fraction is applicable to both foreign and domestic corporations. The business factor is measured by the following items: purchases of goods and materials, amounts paid out for salaries and wages, and gross sales.

Georgia.—The income tax law of 1929, which provided no method of allocation, was changed in 1931. Under the new law, taxable income is to be apportioned to Georgia according to the proportions which tangible property and business within the state bear to total property and business.[22] The fraction is applicable to both foreign and domestic corporations. No measures of the business factor are included in the statute, the matter being left to the tax commissioner, who is empowered to formulate rules and regulations.

Proposal of the Committee of the National Tax Association

The model proposal of the Committee of the National Tax Association should be included in a description of American allocation systems. In the formulation of this proposal, the allocation practices of the leading states were carefully considered and the formula incorporates the most widely used factors for the segregation of taxable income.

In January, 1921, the first plan of the Committee of the National Tax Association was presented.[23] According to this plan, total net income of business corporations was to be apportioned among the states on the basis of tangible property and gross receipts within and without the state, property being weighted at two-thirds and receipts at one-third in the fraction.

In 1922, the Committee on the Apportionment of Business Taxes between the states proposed a new plan of allocation which was based upon the two factors of tangible property and business, each to be weighted at fifty per cent in the fraction.[24] In computing the amount of income subject to apportionment, it was provided that interest, rents, dividends and royalties received in the regular course of business should be specifically allocated to the state in which they are received; such income as specified, if not received in connection with the business, should be deducted from the taxpayer's total net income. Gains from the sale of capital assets, used in connection with, but not in the regular course of business should be allocated to the state in which the assets are located; any gains from the sale of property, not used in connection with the business should be deducted from the taxpayer's total net income. The remainder of the net income was to be subject to apportionment according to the proportions which the tangible property and business within a state bear to the total tangible property and total business. The business of the corporation should be measured by the amounts paid out during the year for (1) materials and supplies and (2) payroll, plus (3) receipts from sales. The property and business ratios were to be averaged, the resulting percentage representing the allocation percentage applicable to the entire net income of the business.

This plan has received more consideration from tax experts than any other scheme of fractional apportionment.[25] As stated previously, it was adopted by the State of North Dakota in 1923. Moreover, it has been incorporated into the federal allocation procedure, as will be explained in the following section.

Methods of Fractional Apportionment Employed by the Federal Government

The status of fractional apportionment in federal procedure has been stated previously;[26] it will be recalled that fractional and empirical methods are used only as a last resort, that is, when a separate accounting is impossible or inapplicable. Nevertheless, a comprehensive fractional procedure is contained in the federal statutes for the allocation of income from the sale of personal property arising from sources partly within and partly without the United States. It is provided that the net income subject to apportionment shall be computed by deducting from gross income those "expenses, losses or other deductions properly apportioned or allocated thereto (United States, a Possession or a foreign country) and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income." Income from the sale of personal property, which is derived from sources partly within and partly without the United States, may be divided into two classes: (A) from sources partly within the United States and a foreign country and (B) from sources partly within the United States and partly within a possession of the United States.[27]

(A) One-half of the net income, which arises partly from sources within the United States and partly within a foreign country, is apportioned according to the ratio of the average value of the taxpayer's property in the United States to the average value of the total property of the taxpayer. The remaining one-half of

[21] *C. L. Supp.* 1913–25, Art. 35, Sec. 2346a6. Also, Income Tax Law Regulations, p. 45 f. *Laws* 1931, Chap. 283.
This formula was proposed by a committee of the National Tax Association in 1922.

[22] *Laws*, Extraordinary Session 1931, Income Tax Act, Sec. 15.

[23] *Bulletin* of National Tax Association, (1921) Vol. VI, No. 4 P. 113.

[24] *Proceedings*, Fifteenth Annual Conference of National Tax Association, P. 198 *et seq.*

[25] For a discussion of the theory underlying this proposal, see P. 109 ff.

[26] See P. 35.

[27] United States Treasury Department, Income Tax *Regulations* 74, Sec. 119, Art. 682.

net income is apportioned according to the ratio of gross sales in the United States to total gross sales.[28]

(B) In 1926, there was a revision of the federal statute relating to the apportionment of income arising from sources partly within the United States and partly within a possession of the United States. Because of disagreement over the "sources of income," several instances of double taxation had arisen in the case of concerns, which bought tobacco and molasses in Puerto Rico for sale in the United States. All of the income of such concerns was taxed in the United States, under authority of the Federal Revenue Act of 1924, Section 217, which provided, in substance, for the taxation of income in the country in which the goods were sold. In Puerto Rico, however, the legislation was based on the principle that income accrues to the country in which the goods were produced, wherever sold, and accordingly, taxes were levied on all of the profits of the buying establishments. Although the federal government followed the general rule of allowing credit for taxes paid in Puerto Rico, no credits were allowed in these cases because the income had not arisen from sources in the latter country, according to the interpretation of the Treasury Department. The net result, therefore, was the taxation of approximately two hundred per cent of the income of concerns which were engaged in the purchase of tobacco and molasses in Puerto Rico for sale in the United States.

In 1924, the Puerto Rican legislature passed a new income tax law, which was designed to remedy this situation in the event that Section 217 of the federal law was revised. The revision was accomplished in 1926 and the Commissioner of Internal Revenue was authorized to formulate processes or formulas, subject to approval by the Secretary of the Treasury, that would be in harmony with those of the Puerto Rican Treasury.

The new method, which was adopted upon the recommendation of Professor Haig, who served as Adviser to the Tax and Revenue Commission of Puerto Rico, represents an application of the proposal by the Committee of the National Tax Association in 1922,[29] of which Dr. Haig was a member. It is provided that one-half of the net income, which is derived from sources partly within the United States and partly within a possession of the United States, shall be apportioned according to the proportion which the average

[28] "Bills and accounts receivable shall be assigned or allocated to the United States when the debtor resides in the United States, unless the taxpayer has no office, or agent, in the United States."

It should be noted that a distinction is made in federal practice between the purchase of goods in another country with subsequent sale in the United States, and the manufacture of goods abroad with subsequent sale in the United States. Under the former case, all of the income from the transaction is ascribed to the United States, that is, the place of sale; in the latter case, the prescribed method of fractional apportionment may be used if it is not possible to establish an independent factory price or if the company's accounting records are inadequate.

[29] See P. 62 f.

value of the taxpayer's property in the United States bear to the average value of the total property of the taxpayer; the remaining one-half of net income shall be apportioned according to the proportion which the taxpayer's business in the United States bears to the total business within the United States and within the possession of the United States. The "business of the taxpayer" is measured by the amount which is paid out during the year for (1) payroll, (2) purchases of materials and supplies, plus (3) gross sales; "such expenses, purchases and gross sales being limited to those attributable to the purchase of personal property within the United States and its sale within a possession of the United States or to the purchase of personal property within a possession of the United States and its sale within the United States."[30]

[30] United States Treasury Department, Income Tax *Regulations* 69, Sec. 217, Art. 328; Income Tax *Regulations* 74, Sec. 119, Art. 682.

CHAPTER V

ALLOCATION PRACTICES IN NEW YORK, MASSACHUSETTS AND WISCONSIN

The allocation practices in New York, Massachusetts and Wisconsin are very significant because of the industrial importance of these states. The purpose of this chapter is to present certain aspects of the three methods in a comparative and descriptive manner. Many of the problems arising out of the application of these methods are placed, necessarily, in other sections of the report.

Development and Nature of the Allocation Formulae

WISCONSIN.—Wisconsin is the pioneer state in the modern era of state income taxation. The law of 1911 was designed to reach every form of income. Domestic and foreign corporations were to be taxed only on that part of their income arising out of business carried on and property located within the state. The act contained general provisions for allocating income within and without the state, leaving the details of administration to the tax commission. In 1923, more definite provisions were adopted:

> Income from a mercantile or manufacturing business, rentals, royalties or operation of any farm, mine, or quarry, or from the sale of property was to be allocated to the state in which the property or business from which it was derived was located. . . . It was left within the discretion of the Tax Commission to determine whether or not a proper allocation could be made by a separate accounting, but if in their judgment a separate accounting would not properly reflect the income assignable to the state, the statute provided a definite form of allocation. First, the net income of the taxpayer, which was specifically allocated to the situs of the property from which derived or to the residence of the recipient, was deducted, and the income was apportioned to Wisconsin on the basis of the ratio which the tangible property and business within the state bore to the taxpayer's total tangible property and business.[1]

However, this law was by no means inflexible as it was provided that in case the above methods were not satisfactory the income should be apportioned according to rules and regulations of the tax commission.

The present method of allocation is based upon the revised law of 1925 according to which the amount of income over and above the non-apportionable income,[2] is apportioned on the basis of the average of the ratios within and without the state of the following three items: tangible property, expenses of manufacturing and

[1] National Industrial Conference Board, *State Income Taxes* (New York, 1930), Vol. I, P. 34 f.

[2] See P. 71.

assembling, and sales. The new law is specific as to the elements included in the allocation fraction so that there is less uncertainty than formerly.

There have been a number of important cases before the courts involving an interpretation of the Wisconsin income tax law. One of the most significant, from an historical standpoint, is that of *United States Glue Co. v. Oak Creek*,[3] in which the allocation problem was first presented before the federal courts. In another case[4] the Supreme Court of Wisconsin upheld a departure from the statutory formula and permitted a determination of taxable income upon the basis of the company's accounting methods.

NEW YORK.—In 1917, New York adopted a franchise tax applicable to mercantile and manufacturing corporations. "For nearly thirty-five years prior to the adoption of the present law, business corporations that are now taxed on the basis of net income were taxed on the value of their capital stock employed in the state, and if the corporation was engaged in business within and without the state its entire assets were segregated in and out of the state in accordance with employment of such assets or capital. There was no plan of segregation or allocation prescribed in the statute itself, nor was there any statutory requirement for the form of report as in the present law. Under the franchise tax on capital stock, the Tax Commission considered all the assets in ascertaining the amount of capital stock employed in the state."[5]

The measure of the present tax is net income. The basis of the tax on domestic corporations is the privilege of exercising its franchise, while that on foreign corporations is for the privilege of doing business within the state.[6] In 1919, Article 9-A was extended beyond mercantile and manufacturing and was made applicable to all corporations engaged in business within the state,[7] except certain real estate and holding companies, public utilities, banks and trust companies.

Corporations which make a fractional apportionment of income usually do so upon the basis of the total value within and without the state of: (a) real and tangible personal property, (b) accounts

[3] 247 U. S. 321 (1918). See P. 36.

[4] *Standard Oil Co. of Indiana* v. *Wisconsin Tax Commission*, 197 Wisconsin 630 (1929). See P. 44.

[5] Powell, H. M., *Taxation in New York* (Clark, Boardman Co., Ltd., New York, 1924), P. 19.

[6] "The tax is for the privilege granted rather than for the exercise of the privilege and therefore every domestic corporation in being and every foreign corporation which remains in the state on November 1 is subject to the tax for the full year then beginning." Commerce Clearing House (1931), *New York State Tax Service*, 245 C. Thus, the measure of the tax is the amount of income received during the preceding year.

[7] The characteristics of the franchise tax are as follows: (1) it is payable whether a profit or loss is shown; in case of a loss the taxpayer is liable for a minimum tax; (2) it is measured by net income for the preceding year; (3) a company would not be liable for the tax if it discontinued business before November first of any year; and (4) it is in lieu of a tax on tangible personal property.

receivable arising out of the sale of personal property and of services performed, and (c) shares of stock of other corporations owned as represented by the physical location of the corporations representing such share stock.[8] The average of these proportions represents the percentage of total income that is taxable by New York State.

No specific method of bookkeeping for the ascertainment of net income is contained in the statute and "it is to be assumed that, as in the case of the Wisconsin Income Tax Law and also under the federal statute, any method of bookkeeping which fairly attains the result, will be acceptable."[9]

In attacking the legality of the allocation provision, a corporation must submit evidence to show that some other method would produce a more equitable result; even then, the court may not decide that the comparative results prove that the taxpayer's method is more equitable than the statutory method.[10] If the statute can be shown to be unfair, a remedy by *certiorari* proceedings is provided in the New York law for the correction of the injustice. The courts have not hesitated to set aside an assessment when it was demonstrated that the statutory allocation rule was unreasonable. In *Societe Anonyme Des Anciens Establishments v. Knapp* (191 App. Div. 701), which arose under the 1917 law, an allocation was set aside because the original Act of 1917 permitted a duplication of accounts receivable by the inclusion in the allocation fraction of goods sold as well as goods manufactured. The court held that each class of accounts receivable should be included but once in the numerator and denominator of the fraction.

The court modified an assessment in the Alpha Portland Cement case,[11] in which an amendment, of 1918, to Article 9-A was disallowed. This amendment provided that if the shares of stock in other corporations actually had a situs in New York such shares could be included in the allocation fraction; but the valuation attached to the shares could not exceed ten per cent of the value of the local realty and local tangible personalty. In computing the tax on foreign corporations, it was declared unconstitutional to include the interest on bond investments as a component part of the income to be allocated if the bonds representing such interest were excluded in segregating the assets. Furthermore, the court held that the full amount—with no limitations regarding the value of the local realty and local tangible personalty—of the shares of stock of other corporations, having a situs outside the state, should be added to the value of assets without the state.

[8] *Tax Law, Art.* 9-A, sec. 214.

[9] Powell, *op. cit.*, P. 17.

[10] See *S. S. Kresge Co.* v. *Bennett,* 51 Fed. (2d) 353, which is discussed at P. 40.

[11] *People ex rel. Alpha Portland Cement Co.* v. *Knapp,* 230 N. Y. 48. See P. 86.

The statutory allocation rule has been upheld in several cases, as explained in chapter three.[12]

MASSACHUSETTS.—The excise tax, which was adopted in substantially its present form in 1919, is measured in part by net income and partly by corporate excess, that is, the excess of the value of the capital stock over the value of certain forms of tangible and intangible property.

The statute provides a definite rule for allocating the income of foreign and domestic corporations. The allocation fraction consists of the three ratios of property, payroll and sales. These ratios are averaged arithmetically, the resulting proportion being used to calculate the percentage of total net income that is taxable by the state.

The question of allocation, as such, has not come up before the courts, although there have been several decisions relating to the scope of the act.

Since 1920, the outstanding features of the tax from the allocation standpoint, are (1) the decision in the *Alpha Portland Cement Co. v. Commission,* 268 U. S. 203, that foreign corporations engaged exclusively in interstate commerce are not subject to the excise tax, and (2) the manufacturing exemptions granted domestic and foreign corporations to the effect that there shall be deducted from taxable net income the same proportion thereof which the fair cash value of machinery owned by the corporation and used in manufacturing in the commonwealth bears to the value of its total assets employed in the commonwealth.[13]

Nature of the Tax

The designation of the tax, i.e., as an income, franchise or excise tax, varies among the states, although in each case it is measured by apportioned net income. In Wisconsin, the tax is imposed directly on the net income of manufacturing and mercantile corporations; in New York and Massachusetts approximately the same result is reached by imposing the tax nominally on the right to do business and designating it as a franchise[14] or an excise, respectively. In adopting this nomenclature, it is very probable that the state

[12] Pp. 38–42. *Bass, Ratcliffe & Gretton, Ltd.* v. *State Tax Commission,* 133 N. E. 122; 266 U S. 271; *Gorham Manufacturing Co.* v. *Travis,* 274 Fed. 975; *S. S. Kresge Co.* v. *Bennett,* 51 Fed. (2d) 353.

[13] Commerce Clearing House, *State and Local Tax Service,* Massachusetts (1931), P. 205.

[14] This is characterized as the franchise "to do" and is defined as a grant "to a corporation, when organized, to perform certain acts or to carry on certain business." Thomas M. Cooley, *The Law of Taxation* (Chicago, 1924), 4th ed., by Clark A. Nichols, P. 1691.

A further distinction is made between franchise and privilege taxes, in which the former applies to annual taxes on domestic corporations; the latter, to annual taxes on foreign corporations.

legislatures intended to avoid state and federal constitutional restrictions which might be invoked against a pure income tax.[15]

The exact nature of the tax, i.e., whether it is a property tax, a franchise tax, or an income tax, is of more than academic importance since the right to tax interest from federal obligations and royalties from patents and copyrights has been made to turn partially upon this question. Furthermore, the legal interpretation of the nature of the tax has significant bearings on the problem of allocation.

In New York, the tax under Article 9-A "has been held consistently to be an excise tax imposed upon domestic and foreign corporations for privilege of exercising corporate franchise. The tax was deemed not to be an income tax (*New York v. Jersawit*, 1924, 263 U. S. 493) although measured by income from property of corporation, part of which income might be derived from non-taxable property.[16]

The Massachusetts tax presents difficulties from the standpoint of classification since several factors enter into the computation. "One factor is indisputably net income from Massachusetts business, while another factor, corporate excess, is more nearly property allocable to Massachusetts. The tax resulting from the two factors mentioned is called by the statute an excise tax on the privilege of doing business in Massachusetts." [17]

Definition of Income

NEW YORK.—The franchise tax, as levied on foreign and domestic corporations under Article 9-A of the Tax Law, is measured by entire net income, which, presumably, is the same as the entire net income which such corporation is required to report to the United States, plus any net income not deductable under the definition of entire net income, *i.e.*, "(1) items or sums excluded from the definition of gross income in use by any other taxing authority, (2) dividends received on stocks, (3) taxes paid to the government of the United States on either profits or net income, (4) any specific amount allowed by any other taxing authority, or (5) losses sustained by the corporation in other fiscal or calendar years, whether deducted by the government of the United States or not. Bona fide gifts to a corporation other than unpaid salaries or compensation due to officers, for which no consideration has been given or made by the corporation itself, shall not constitute income nor be included in entire net income for the purpose of this section." [18]

MASSACHUSETTS.—Net income is defined as the amount which is required under the return by the corporation to the federal government according to the federal revenue act applicable for the period, "adding thereto any net losses, as defined in said federal revenue act, that have been deducted and all interest and dividends not so required to be returned as net income which would be taxable if received by an individual inhabitant of the commonwealth; provided that net income as defined in this paragraph shall not include interest from bonds, notes or certificates of indebtedness of the United States or of any federal instrumentality, if such interest is by the constitution of the United States, or by act of Congress exempt from taxation under this chapter." [19]

[15] However, it is not always possible to avoid constitutional limitations. See *The Macallen Company* v. *Massachusetts*, 279 U. S. 620 (1929). However, see also *Educational Films Corporation* v. *Ward*, 282 U. S. 379 (1931).

[16] Prentice-Hall, *New York Tax Service*, (1931) paragraph 2207.

[17] Commerce Clearing House, *State and Local Tax Service*, Massachusetts (1931) P. 205.

[18] *Tax Law*, 1931, Art. 9-A, Sec. 208, 3.

WISCONSIN.—The tax is based upon net income, which means "gross income less allowable deductions." Gross income includes the total amount of any kind of income from any source whatever. For business enterprises, the assessment is based upon the amount of income less the expenses incurred in the earning of such income. In 1927, Wisconsin adopted the method of assessing the income tax in any year on the basis of the average net income of the three years immediately preceding. Beginning in 1933, however, the tax is to be levied on the income of the preceding year.

Non-apportionable Income

WISCONSIN.—The Wisconsin plan designates a category of non-apportionable income, i.e., income having a fixed situs, which must be set apart before the allocation formula is applied.[20] In most of the states, this process is referred to as specific allocation. Non-apportionable income includes certain classes of income, the situs of which may be said to coincide with that of the property from which it is derived, *e.g.*, profits or losses from the sale of capital assets and rents and royalties from property; if the property is located outside of Wisconsin, it is not taken into account. On the other hand, if the property has a situs in Wisconsin, the entire income is apportioned to Wisconsin.[21]

[19] *General Laws*, chap. 63, sec. 30, 5.

[20] The practice of the federal government is similar to that of Wisconsin, inasmuch as certain income specified in Section 119A of the 1928 Revenue Act—interest, dividends, royalties and profit from sale of real estate—is regarded as non-apportionable and is allocated in entirety to the United States, when the situs of the property is in the United States.

[21] "Only the net income which follows the situs of property can be deducted and only the excess of interest and dividends received over the amount of interest paid can be deducted, e. g., a corporation has total net income of $50,000; of this $10,000 is from rent and $10,000 from interest and dividends. These amounts are non-apportionable income as they take on the situs of the property and residence of the recipient respectively and are either taxable in full or not at all according to situs within and without the state. Assume, however, that 'related expenses' applicable to rent received, consisting of depreciation, repairs, collection expenses, etc., amount to $4,000 and interest paid amounts to $8,000. Then net rent is $6,000 and excess of interest and dividends over interest paid is $2,000, a total of $8,000 . . . Therefore, deduction from total net income is only $8,000 and apportionable income would be $42,000 instead of $30,000 (as without these two provisions) . . . In many instances more income will be taxable in Wisconsin than before." Commerce Clearing House, *Wisconsin Tax Service* (1931), paragraph 210. 101.

MASSACHUSETTS.—Substantially the same rules apply to foreign and domestic corporations, although there are some deviations. Domestic corporations are required to allocate, entirely to Massachusetts, the following classes of income: (1) interest and dividends included in net income; (2) gains from sale of intangible capital assets; (3) gains from sale of tangible capital assets (real estate and tangible personal property) located in Massachusetts. The gains from the sale of tangible capital assets situated without the state are allocated in entirety to other states.[22]

Foreign corporations are required to allocate, entirely to Massachusetts, the following classes of income: (1) gains from sale of tangible capital assets located in Massachusetts; (2) interest from (a) Massachusetts corporations (except trust companies); (b) associations, partnerships or trusts having transferable shares and having a principal place of business in Massachusetts.

NEW YORK.—In New York practice, the problem of specific allocation does not arise in the same manner as in Wisconsin and Massachusetts. The only deductions from gross income that are specified on the return consist of those which are allowed by the federal government.[23] It is important, in this connection, to bear in mind that assets, and not income, form the basis for apportionment where the business is not conducted entirely in New York State. The problem, then, arises in this form: Is the corporation permitted to include all of the assets from which such income arises? This was the chief question in the Alpha Portland Cement Case which is explained in a previous section.[24]

Corporations Entitled to Make an Apportionment

It is not always an easy task to determine when a corporation is entitled to apportion its income among several states. There are marginal cases in which complications arise because of the legal technicalities involved. The purpose of this section is to suggest the problem and state the general rule that is followed in the three states.

NEW YORK.—The mere sale of goods, wares and merchandise outside the State of New York does not entitle a corporation to allocate income within and without the state for taxation purposes. In order for a corporation to use the segregation formula in determining the proportion of income taxable by New York, it must maintain a definitely organized, or permanent, branch establishment within another state. In the absence of such a branch, when sales are made in other states, the entire net income is taxable by New York.

[22] Capital assets denote the property of the corporation, regardless of whether or not it is used in connection with the business. Such assets do not include the sale of stock in trade in ordinary course of business or other property which would properly be included in the taxpayers' inventory.
[23] The method of determining federal net income is beyond the scope of this report.
[24] See P. 68.

MASSACHUSETTS.—The criterion for determining when a corporation is entitled to use the apportionment formula is similar to that of New York. Ordinarily, a corporation will not be deemed to be doing business outside Massachusetts unless it maintains a bona fide office, store, factory or other regular or established place of business outside the state. The mere sending of an agent into other states to solicit business, or selling to individuals or corporations outside of Massachusetts, or owning tangible property outside Massachusetts will not be construed as carrying on business outside Massachusetts.

An exception to this rule, however, was introduced in *Carlos Ruggles Lumber Company v. Commonwealth.*[25] In this case, it was held that a domestic corporation which was engaged in purchasing lumber in one group of states, excluding Massachusetts, and shipping it to other states, including Massachusetts, was entitled to an allocation of income within and without the state, although it neither owned nor rented a place of business outside the Commonwealth.

WISCONSIN.—The test as to when an enterprise is entitled to an apportionment is not clear but it seems to turn largely on the question of the situs of sales. One of the chief difficulties lies in the present application of the old Glue Case rule[26] which held, in effect that the profits from the sale of goods which were manufactured in Wisconsin were taxable in Wisconsin regardless of the territorial point, i. e. outside the state, at which the sale or delivery of the goods occurred. At the time of the decision in this case the allocation provisions in the law were not so definite as at present.[27] If the rule is still in effect, those companies falling within the scope of the opinion in the Glue Case are not legally entitled to an apportionment.

Status of Fractional Methods

NEW YORK.—In this state, no record is kept of the number of corporations which make returns according to the different methods of allocation. The percentages expressed in this section are not official statements, but are simply estimates made by the writer upon the basis of the scanty information that is available. Approximately one-third of the business corporations of the state are engaged in a combined local and interstate business, i.e., between ninety and one hundred thousand corporations. Of this number, possibly seventy per cent use the statutory segregation formula.[28] Approximately five per cent follow the method of separate accounting, while the remaining twenty-five per cent use an alternative

[25] 261 Mass. 450, 158 N. E. 899 (1927).
[26] *United States Glue Co.* v. *Oak Creek,* 247 U. S. 321 (1918). See P. 36. See also P. 83 for a more complete statement concerning the allocation of sales.
[27] See Pp. 66, 83.
[28] See P. 67 f.

allocation fraction. The bases of the alternative fraction are not specified in the law,[29] but the customary practice seems to be the use of a fraction that is based upon an average of the ratios within and without the state of the following factors: (1) property, (2) sales and (3) costs of operation. These three factors are not necessarily weighted equally, but may be adjusted according to the nature of the business.

MASSACHUSETTS.—In Massachusetts the fractional method is used in ninety-nine per cent of the cases which require an allocation of income.[30] It is to be noted that only foreign corporations are permitted to use a separate accounting in computing taxable income. However, if it can be demonstrated that the statutory fraction, consisting of the ratios of property, payroll and sales within and without the state, does not operate fairly, the corporation may follow an alternative procedure, in which either one or two of the ratios is dropped.[31]

WISCONSIN.[32]—There are 1,305 corporations out of a total of 20,866, that are engaged in interstate business of a nature such as to require division of net profits within and without the state. Of this number there are 706 corporations,[33] or approximately fifty-four per cent, that are required to use the general apportion-

[29] Authority for the formulation of an alternative fraction is contained in the law. "If it shall appear to the tax commission that the segregation of assets shown by any report made under this article does not properly reflect the corporate activity or business done, or the income earned from corporate activity or from business done in this state because of the character of the corporation's business and the character and location of its assets, the tax commission is authorized and empowered to equitably adjust the tax upon the basis of the corporate activity or the business done within and without the state rather than upon capital or assets only." (Subd. 11 *amended by* L. 1931, *ch.* 515, *in effect April* 21, 1931.) New York *Tax Law* (1931), Art. 9A, Sec. 211, Subd. 11.

[30] Letter to the writer from Commissioner Henry F. Long, under date of October 26, 1931.

A few of the large corporations which use the fractional method are: Great Atlantic & Pacific Tea Co.; General Electric Co.; Pittsburg Plate Glass Co.; United Shoe Machinery Co.; Standard Oil Co. of New York; International Harvester Co. of America; United Drug Co.; Gillette Safety Razor Co. and Ford Motor Co.

[31] "In a case where only two of the foregoing three rules are applicable, the said remainder of net income of the corporation shall be divided into two equal parts only, each of which shall be apportioned in accordance with one of the remaining two rules. If only one of the three rules is applicable, the part of the net income received from business carried on within the Commonwealth shall be determined solely by that rule." *General Laws* of Mass. (1921), chap. 63, sec. 38, 3.

[32] Most of the material in this division is contained in a letter to the writer from Commissioner W. J. Conway, under date of Aug. 17, 1931.

[33] Some of the large nationally known corporations which employ the general apportionment basis are: E. I. DuPont de Nemours & Co.; Armour & Co.; Ford Motor Co.; International Harvester Co.; Westinghouse Lamp Co.; Fleischmann Co.; American Radiator Co.; Simmons Co.; Pittsburg Plate Glass Co.; National Biscuit Co. and Borden Co.

ment method, i. e., an average of the ratios of tangible property, cost of manufacturing, and sales.[34]

It is the practice of the Commission to ascertain whether or not the corporation maintains an adequate system of accounting for the activities in which it is engaged. If the accounting methods are not satisfactory as a basis for reporting taxable income, then the general apportionment fraction is applied. However, if the company refuses to file a tax return or submit such information as is necessary for the application of the apportionment fraction, the Commission may make an assessment on the basis of estimated income. This procedure is called a "doomage assessment," and is usually so high that little difficulty is experienced in obtaining returns after the first assessment. Some other method, such as percentage of turnover, may be used in the absence of proper records and accounts.

The fractional method is used in a greater number of cases than the method of separate accounting because "most of our important foreign corporations are engaged in some form of manufacturing or processing, and it generally occurs that only a part of the whole business organization is maintained here and the balance is maintained or located without the state. That is to say, a manufacturing or assembly unit may be located here, but the general office and sales organization, together with other manufacturing units are located entirely without the state, or the converse may be true, a selling agency or branch may be all that is located here while the balance of the activities are located outside of the state, or it may occur that only a storage warehouse either owned or leased, is located here with no sales department or agency attached thereto"[35] . . .

Status of Separate Accounting

NEW YORK.—Separate accounting is apparently the least satisfactory of the methods of allocation as it is used in only about five per cent of the cases requiring an apportionment of income among two or more states.

MASSACHUSETTS.—Less than one per cent of the cases in which an allocation is necessary are handled on the separate accounting basis. The use of this method is open only to foreign corporations and relatively few have requested permission to use it. The num-

[34] "Where, in the case of any person engaged in business within and without the state of Wisconsin and entitled to an apportionment of his income as herein provided, it shall be shown, to the satisfaction of the Tax Commission, that the use of any one of the three ratios above provided for gives an unreasonable or inequitable final average ratio because of the fact that such person does not employ, to any appreciable extent in his trade or business in producing the income taxed, the factors made use of in obtaining such ratio, this ratio may, . . . be omitted in obtaining the final average ratio which is to be applied to the remaining net income." Wisconsin *Statutes*, 1929, chap. 71.02 (3d 4).

[35] Conway, *loc. cit.*

ber following this method varies from year to year, but will average about twenty-five corporations.[36] Such discrimination against domestic corporations regarding the use of this method apparently causes little dissatisfaction on the part of the taxpayers.

WISCONSIN.—The method of separate accounting is permitted in forty-six per cent of the cases. It is the practice of the Commission to ascertain whether or not the accounting records are adequate to serve as the basis of the return. If not, then the general apportionment fraction is applied.

In the case of foreign corporations with branches or subsidiaries in Wisconsin, the tax commission may require that records be kept, and the failure to comply with such a demand is subject to penalty. No specific method of bookkeeping is prescribed. The accounts ordinarily submitted for tax purposes contain the same information as that required by the federal government. Supporting schedules of information on certain items such as depreciation, amortization, bad debts, capital gains or losses, taxes, dividends received, repairs, interest paid, etc., are required. Balance sheets, profit and loss statements, and the proof of surplus are required, as well as a statement explaining the difference shown by the books and the income declared on the tax return. Various items on income and expense are compared in order to discover any large variations in the amounts or ratios thereof. The presence of such variations may signify the shifting of income from Wisconsin, or an unwarranted loading of expenses against that state and in order to verify the return the company may be required to submit to a field audit.

Industries to Which Separate Accounting is Most Applicable

WISCONSIN.—In connection with this phase of the problem, an interesting and lucid statement was made by Commissioner Conway[37] which is quoted here in entirety.

> It is our experience that an acceptable method of separate accounting is possible only in a limited number of types of business. The following represents the principal types . . .
>
> 1. Trading companies
> 2. Construction companies
> 3. Manufacturing companies manufacturing a complete product and maintaining a complete sales organization therefor within the state
>
> Trading companies can usually report on a separate basis because the scope of their activity is usualy limited to the trading area adjacent to the location of the establishment. Usually the only items of apportionment will be the purchase department expense if the purchases are made by a central purchasing agent, allocation of some administrative overhead expense, and perhaps of some nominal accounts such as federal income tax payments and interest payments on general loans incurred on behalf of more than one establishment. The operating results of a trading concern are very closely

[36] Letter to the writer from Commissioner Henry F. Long under date of September 22, 1931.

[37] *Supra*, note 32.

> dependent upon the character of the population, the buying habits, and resources of the particular territory served, and for this reason a separate accounting tends more accurately to reflect the true conditions as regards the profits earned.
>
> A construction company engaged in construction projects such as buildings, dams, concrete roads and bridges, sewers, etc., almost invariably keeps accurate jobs and construction cost records for each project . . . and, with the exception of a few general items of administrative overhead, the costs are applied directly and the profits on each are determined separately from the other. This situation is ideal for separate accounting. It also reflects a more accurate picture of the profits realized than a general apportionment, since the latter tends to average the profits over all projects performed, whereas construction business by its very nature is such that large variations in profits between different projects will and do occur.
>
> We also find certain instances of manufacturing concerns which maintain a complete and integrated organization, incorporating all elements of an independent concern; that is, owning and employing their own property, performing all of their own manufacturing or assembling operations, maintaining their own sales organization, doing their own financing, and keeping separate and distinct books of account. A few instances of this do occur within this state where the establishment is a branch or subsidiary of a larger company employed in the same general line of business, and when such branch or subsidiary is conducted and operated as a distinct and self-sustaining unit it will lend itself to an accurate separate accounting.

It should be noted, however, that, "it has been our experience during the past five years that the separate accounting method is becoming less satisfactory, with the result that the apportionment method is being employed more frequently than ever before as a solution to the problem."[38]

MASSACHUSETTS.—It will be recalled that Massachusetts has a peculiar provision which permits only foreign corporations to make a return on the basis of separate accounting. However, among the foreign corporations, the method is most applicable to foreign investment corporations and to a few trading corporations that carry on no other function in Massachusetts than that of selling.[39]

Devices for Tax Evasion

The method of evading the allocation requirements are described in another section,[40] but they are particularly apropos here inasmuch as the problem arises on the largest scale in these three states. The most general practice, when a corporation is engaged in business in several states, is to organize, in another state, a separate sales or distributing corporation which is owned entirely by the manufacturing corporation. By this method, the profits may be diverted through inter-corporate contracts which disregard the economic importance of the various entities.[41] In Wisconsin another method has come to light in which patent rights are transferred by a Wisconsin manufacturing cor-

[38] Conway, *op. cit.*

[39] Note 36, *supra*.

[40] See P. 47.

[41] See Magill, Allocation of Income by Corporate Contract, 44 *Harv. L. Rev.* 935 (April 1931).

poration to a subsidiary corporation, which is organized under the laws of some other state, the purpose being to reduce the income of the Wisconsin manufacturer by some large royalty payments to its foreign subsidiary.

It is highly probable that these are exceptional cases, but nevertheless there is a real problem in obtaining true statements from corporations of their actual income for taxation purposes. The adoption of uniformity in allocation is a fundamental step in removing the temptation to divert taxable income. Most of the statutes empower the Commission to determine the real situation and make a reassessment of the tax, but this is a palliative, rather than a remedy for this type of tax evasion.

The Consolidated Return

The case of a single corporation whose activities extend into several states entails a difficult problem in determining the amount of income arising within a certain state. But the problem becomes even more complicated when the corporation doing business in the state is also a member of an affiliated group of corporations some of which operate in other states. The income reported by any single unit of the group may be affected considerably by inter-company transactions, many of which are of an artificial nature. Carried to the extreme, this may result in a particular subsidiary operating at a ridiculous loss, while the concern as a whole shows a profit.

In Wisconsin, the consolidated return has been used since 1912, although no specific statutory provision was made until 1927. The Commission is authorized to require such returns from affiliated corporations either as parent or subsidiary or through stock ownership by the same interest, or where income of such affiliated corporation is regulated through contract or other arrangements, when it is necessary in order to determine the taxable income received by any one of the affiliated or related corporations.[42] This section does not grant the taxpayer the right to file consolidated returns at his own option, although it may be permitted in certain instances.

The New York practice relative to this form of return was clarified by an amendment to the law in 1925.[43] Before that time, the statute made a provision for a return on the basis of consolidated income by a corporation which was the owner of another corporation operating within New York where the owner did an intra-

[42] See *Palmolive Co.* v. *Conway* (1930), 43 Fed. (2d) 226 and *Buick Motor Co.* v. *Milwaukee* (1930), 43 Fed. (2d) 385. In the latter case, the request on the part of the tax commission for a consolidated return was refused by the company on the ground that the parent company was entirely outside the state and could not be required to file a return. However, the Commission made an audit in which it was shown that a fair profit for the selling subsidiary could be computed accurately on the basis of contracts in force between the company and independent dealers.

[43] Article 9A, Sec. 211, Subd. 9.

state business here. However, it made no provision, until the 1925 amendment, for such a return by the corporation which was owned. The irregularities that might develop out of such an omission in the law are well illustrated in the Studebaker case,[44] in which it was held that a franchise tax was improperly assesed against the subsidiary corporation upon the basis of the consolidated income of the subsidiary and parent. While the new amendment has not been subjected to a test it is presumed to be legal since the consolidated return is now used by many companies.

The Massachusetts statute provides that if two or more foreign or two or more domestic corporations, which are subject to the excise tax, participated in the filing of a consolidated return of income to the federal government, they may, at their option, be assessed upon their combined net income. It is to be noted also that a corporation which owns or controls substantially all the capital stock of another corporation, or a corporation so owned and controlled, may apply to have the tax imposed upon the income of the two corporations jointly; and in such instances the Commissioner may require as a part of the return a copy of the consolidated return as made to the federal government. "In case a subsidiary of a foreign corporation shows a loss when the consolidated return of the parent and the subsidiary shows a profit, if the arrangement between the parent and subsidiary appears to be arbitrary and that the parent has absorbed the profits of the subsidiary through intercompany transactions, we allocate to Massachusetts a portion of the consolidated profit. Assuming a subsidiary corporation and a parent corporation have been accepting our method of apportionment of the consolidated income right along we would ordinarily permit them to continue with this method, even though in a particular year the subsidiary might show a loss when the consolidated return showed a profit. As a matter of fact this situation rarely occurs."[45]

[44] *People ex rel. Studebaker Corp. of America* v. *Gilchrist*, 244 N. Y. 114 (1926). This case is explained at P. 52.

[45] Letter to the writer from Commissioner Henry F. Long, under date of October 26, 1931.

CHAPTER VI

NON-UNIFORM BASES OF FRACTIONAL APPORTIONMENT

The bases of fractional apportionment consist of tangible property, sales, payroll and other factors, which are shown in Table I. In all, there are ten different bases or criteria which are used by the various states. Moreover, little uniformity exists in the use of these ten bases for frequently they are weighted differently in different states. Practically all of the states use the property basis to some extent, but the weights which are attached to this factor range from 33 1/3 per cent to 100 per cent. In Table I, it is shown that the property basis is not applicable to all types of corporations in the various states so that it might be said that the weight which is attached to property ranges from zero to one hundred per cent.[1] In order to appreciate fully the extent to which non-uniformity prevails, it is necessary to consider separately the bases of the allocation fractions which were described in the two preceding chapters.

Property

Fifteen states[2] use real estate and tangible personal property in some manner as a criterion of net income arising from sources within the state.

By the very nature of tangible property, the definition is fairly uniform and, therefore, causes little difficulty from the standpoint of overlapping jurisdictional claims. The statutes usually specify that tangible personal property "shall be taken to mean corporeal personal property, such as machinery, tools, implements, goods, wares and merchandise, and shall not be taken to mean money, deposits in bank, shares of stock, bonds, notes, credits or evidences of an interest in property and evidences of debt."[3]

Most of the allocation fractions are predicated on the assumption that the location of tangible property determines the situs of a part or all of the income, and, therefore, the state can claim that proportion of total income which is represented by the ratio of real and tangible personal property within the state to the total real and tangible personal property. In many cases, the amount of income allocable to a state will be greater when real estate is used as the sole criterion of allocation than when it is combined with other criteria. The extent to which a jurisdiction relies upon real estate, as an allocation criterion, is indicated by the weight

[1] See P. 82 f.

[2] Connecticut, Georgia, Idaho, Massachusetts, Mississippi, New York, North Carolina, North Dakota, Oregon, South Carolina, Utah, Vermont, Virginia, Washington and Wisconsin.

[3] *Tax Law* of New York, Art. 9A, Sec. 208.

TABLE I

COMPARATIVE WEIGHTS ATTACHED TO ALLOCATION RATIOS

	Tangible property	Gross receipts or sales	Payroll	Shares of stock of other corporations owned	Purchases	Manufacturing costs	Business	Certain accounts receivable	Net cost of sales	Cost value of physical assets
Arkansas[1]	......	......	......	......	......	100	......	......	......	......
	......	100	......	......	......	......	......	......	......	......
California	33⅓	33⅓	33⅓	......	......	......	......	......	......	......
Connecticut[2]	0	100	......	......	......	......	......	......	......	......
	100	0								
Georgia	50	......	......	......	......	......	[3] 50	......	......	......
Idaho[4]	33⅓	33⅓	33⅓	......	......	......	......	......	......	......
Massachusetts	33⅓	33⅓	33⅓	......	......	......	......	......	......	......
Mississippi[5]	......	......	50	......	......	......	......	......	......	50
			....						100	......
Missouri	......	[6] 100	......	......	......	......	......	......	......	......
Montana[7]	......	......	......	......	......	......	......	......	......	......
New York	33⅓	......	......	33⅓	......	......	......	[8] 33⅓	......	......
North Carolina[9]	50	......	......	......	......	[14] 50	......	......	......	......
	50	50				......				
North Dakota	50	......	......	......	......	......	[10] 50	......	......	......
Oklahoma[11]	......	......	......	......	......	......	......	......	......	......
Oregon	33⅓	33⅓	33⅓	......	......	......	......	......	......	......
South Carolina[12]	100	0	......	......	......	......	......	......	......	......
	50	50								
	0	100								
Tennessee	0	100	......	......	......	......	......	......	......	......
Utah	33⅓	33⅓	33⅓	......	......	......	......	......	......	......
Vermont	33⅓	......	......	33⅓	......	......	......	[13] 33⅓	......	......
Virginia	50	50	......	......	......	......	......	......	......	......
Washington	33⅓	33⅓	......	......	......	[14] 33⅓	......	......	......	......
Wisconsin	33⅓	33⅓	......	......	......	[14] 33⅓	......	......	......	......

[1] Mercantile companies use the gross sales ratio and manufacturing companies use the cost of production ratio.

[2] The property ratio is applicable to companies deriving profits principally from ownership, sale or rental of real estate, or profits principally from manufacture, sale or use of tangible personal property. The gross receipts ratio is applicable to companies deriving profits principally from holding or sale of intangible property, but it is rarely used.

[3] The criteria of "business" are not specified in the statute.

[4] The law provides that the "apportionment shall be made under rules and regulations prescribed by the Commissioner, giving consideration to sales, property and payroll and such other factors as may be deemed applicable."

[5] Manufacturing companies use a fraction that is made up of two ratios; cost value of physical assets and payroll. Trading corporations use a ratio that is based upon net cost of sales and the rate of turnover is also taken into consideration.

[6] The numerator of the Missouri fraction is made up of "gross sales or amount of business transacted wholly in Missouri, plus one-half of gross sales or amount of business transacted partly within and partly without the state; the denominator consists of "total sales or total amount of business transacted."

[7] Montana has no allocation fraction.

[8] The ratio of "Bills and Accounts Receivable" includes those arising (1) from merchandise wherever sold if manufactured within the state, and from merchandise sold within the state wherever manufactured; (2) from trading in merchandise not permanently located outside New York when the order for it is received within the state; and (3) income from services performed by any officer or employee connected with an office within the state.

[9] In the case of manufacturing corporations, the apportionment is based on the property and manufacturing costs ratios; trading companies use the property and sales ratios.

[10] The "business" factor is measured by the three ratios of sales, payroll and purchases.

[11] No information is yet available concerning the Oklahoma practice.

[12] Foreign corporations engaged in manufacturing in South Carolina use the property ratio; foreign corporations engaged in buying and selling use the gross sales ratio; an average of the two ratios is applicable to net income derived from sale of personal property of foreign corporations produced (in whole or in part) by the taxpayer without and sold within the state.

[13] Bills and accounts receivable arising from the sale of personal property.

[14] Manufacturing costs include (1) total cost of all goods, materials and supplies used in manufacturing, processing or assembling within the state regardless of where purchased; (2) total wages and salaries paid or incurred in the state; (3) total overhead or manufacturing burden properly assignable to such manufacturing, processing or assembling activities within this state.

which is attached to this factor in the allocation fraction. As is shown in Table I, the weights which are attached to property range from zero to one hundred per cent. Extreme cases are represented by the Connecticut fraction, on the one hand, which is based solely on the property ratio in apportioning the income of manufacturing corporations;[4] and, on the other hand, the Tennessee fraction which is based entirely on the gross-sales factor. In a mid-way position are North Dakota, Georgia and North Carolina in which the practice is to weight the property ratio at fifty per cent. In seven states—Massachusetts, New York, California, Idaho, Oregon, Utah and Vermont,—the property factor is weighted at thirty-three and one-third per cent.

Gross Receipts or Sales

Fifteen states,[5] either by law or by regulation, make some use of the gross receipts or sales ratio. Two states—New York and Vermont—use the sales factor as represented by certain accounts receivable, while Mississippi requires a calculation and apportionment of the net costs of sales.

As is shown in Table I, the weights which are attached to the sales ratio range from one hundred per cent to zero. In Tennessee and Missouri, gross sales constitute the sole basis of allocation. On the other hand, in the Connecticut fraction no weight is attached to the sales ratio, except in isolated instances when it is weighted at 100 per cent.[6] There are several states which are mid-way between these two extremes. According to the Virginia practice, fifty per cent of taxable income is apportioned on the basis of sales. Nine states[7] attach a weight of thirty-three and one-third per cent to the gross receipts ratio.

In addition to the varying weights which are attached to the sales factor, non-uniformity prevails in determining the situs of sales. The line of demarcation between intrastate and interstate sales is not sharply drawn. Much confusion arises out of conflicting claims to the same sales, or in other words several states may include the same sales in the numerator of the allocation fractions.[8] The diversity of rules underlying the situs of sales can be better illustrated in a brief review of the practices in several states.

[4] The property ratio is applicable to companies that derive profits principally from ownership, sale or rental of real estate, or from the manufacture, sale or use of tangible personal property.

[5] Connecticut (sales ratio is used only in the case of companies which derive profits principally from the holding or sale of intangible property), California, Georgia, Idaho, Massachusetts, Missouri, North Carolina, North Dakota, Oregon, South Carolina, Tennessee, Utah, Virginia, Washington and Wisconsin.

[6] See note 5, *supra*.

[7] California, Idaho, Massachusetts, Oregon, Utah, Washington, Wisconsin, Vermont and New York.

[8] This question is considered in more detail in chapter seven.

WISCONSIN.—In Wisconsin, the treatment of sales may be summarized, as follows:

Decided tendency toward continuing the effect of the Glue Case Rule[9] even when an apportionment is permitted, has been evidenced. Where either a foreign or domestic manufacturing corporation engaged in business within and without the state operates a factory within Wisconsin, the general practice now is to require that the selling value of the product manufactured in Wisconsin be credited to that state in the sales ratio of the apportionment computation, although the product manufactured in the state is actually sold from a regularly established and maintained bona fide sales office outside Wisconsin.[10]

Goods, products or property outside of state and charged, either directly or by way of home office in Wisconsin, to branch offices outside of state and thence sold and delivered to customers outside state, should be allocated to sales without state; but a Wisconsin corporation engaged in manufacturing exclusively in Wisconsin is taxable on all the income received from the sale of its products, even though a part or all of such products is sold through branch offices situated outside of the state.[11]

The only sales which are not apportioned to Wisconsin are those sales of products made by branch offices which are located outside of Wisconsin to customers outside the state, of products purchased outside of Wisconsin.[12]

NEW YORK.—In the case of New York, the allocation fraction includes the ratio based upon certain accounts receivable, in which are included: bills and accounts receivable (1) from merchandise wherever sold, if manufactured within the state, and from merchandise sold within the state, wherever manufactured; and (2) from trading in merchandise not permanently located outside the state where the order for it is received within the state. The question arises as to whether accounts receivable from goods manufactured within the state can be said to belong within the state if sold from a stock or goods located at a regular place of business outside of the state at the time of sale. Under such circumstances the accounts receivable may be taxed in the two jurisdictions of manufacture and sale. Apparently, this kind of a situation is avoided, and it seems, from the Form for Return of Corporate Income, that the bills and accounts receivable that are allocable to New York include those arising from sales in other states where the corporation does not maintain a permanent or continuous place of business and where such sale is reported back and accepted at an office of the corporation located in New York; the implication being that in case of a regular place of business outside the state and at a point the sale would be accepted, such sale would therefore be allocated outside of New York State.[13]

[9] This rule, in effect, is that the profit on the sale of goods manufactured in Wisconsin by a domestic corporation is taxable in Wisconsin regardless of the point at which the sale or delivery of the product is made. *U. S. Glue Company* v. *Oak Creek*, 247 U. S. 321. Discussed at Pp. 36, 73.

[10] Commerce Clearing House, *Wisconsin Tax Service* (1931), paragraph 210.01.

[11] Anderson's Madison Service, Volume 6, page 29, quoted in Prentice-Hall *State and Local Tax Service*, Volume 1, 1929–31, paragraph 3523.

[12] Prentice-Hall, *State and Local Tax Service*, Volume 1, 1929–31, paragraph 3523.

[13] Form 3 I. T., Section 39C. Also, Commerce Clearing House, *New York Tax Service*, 1930–31, paragraph 441.a.

If a corporation had a factory without the state and it also maintained a place of business within the state, from which the goods were sold, the accounts receivable would be taxable in New York.

MASSACHUSETTS.—The general rule in Massachusetts provides for the allocation to that state of gross receipts from sales,

Except those negotiated or effected in behalf of the corporation by agents or agencies chiefly situated at, connected with or sent out from premises for the transaction of business owned or rented by the corporation outside the commonwealth and sales otherwise determined by the commissioner to be attributable to the business conducted on such premises.[14]

It seems that Massachusetts, in effect, starts with the idea that all sales are presumed to be made within the state and that this presumption may be overcome only to the extent that the taxpayer demonstrates that sales have been made out of offices located outside of the state. It seems that if a corporation has an office in Massachusetts and no office or premises outside of the state all the sales acording to the statute would be made within the state.[15]

However, this statement must be qualified in accordance with the Carlos Ruggles Lumber case[16] in which it was held that a Massachusetts corporation, with no permanent or temporary place of business outside the state, was entitled to have its taxes allocated on the basis of a combined business within and without the state. The court said: "It is not essential to interstate commerce that persons engaged in it have established places of business in the several States or in more than a single State." The obverse of this ruling is contained in the statute which provides that "a rule shall not be deemed to be inapplicable merely because all the tangible property or the expenditures of a corporation for wages, salaries, commissions or other compensation, or the gross receipts of the corporation are found to be situated, incurred, or received without the commonwealth." [17]

CALIFORNIA.—It is considered that sales are made in California "if and when they are negotiated, consummated and effected in behalf of taxpayer by agents or agencies chiefly situated at, connected with, or sent out from premises for transaction of business owned or rented by taxpayer situated within the state. Sales consummated as a result of orders received through the mails or arranged by telegram or other similar mode of communication, originating or terminating at a corporate domicile within this state, are allocable within the state of California. The mere fact that a shipment of goods is destined to a point outside of California does not make it an outside sale." [18]

[14] *General Laws* of Mass., Ch. 63, Sec. 38 (6).
[15] Prentice-Hall, *State and Local Tax Service*, Vol. I, 1929–31, paragraph 3523.
[16] *Carlos Ruggles Lumber Co.* v. *Commonwealth*, 1927, 261 Mass. 450, 158 N. E. 899. See P. 73.
[17] *General Laws* of Massachusetts, Chapter 63, Section 38 (9).
[18] Regulations issued by the Franchise Tax Commissioner, quoted in Commerce Clearing House, *Corporation Tax Service, State and Local*, 1931, paragraph 1131.10.

NORTH DAKOTA.—The North Dakota law provides that: "Receipts from sales and other sources shall be assigned to the office, agency, or place of business of the corporation at or from which the transactions giving rise to such receipts are chiefly handled and attended to with respect to the negotiation and execution." [19]

VIRGINIA.—"Sales in Virginia, regardless of where goods are manufactured, and receipts from sales of goods manufactured in Virginia, regardless of where sold, are allocable to Virginia." [20]

Payroll

Seven states[21] use the item of payroll as a criterion for allocating income. As is shown in Table I, five states attach a weight of thirty-three and one-third per cent to this ratio. In general, the definition and interpretation of "payroll" is definite and includes the expenditures of the corporation for wages, salaries, commissions and other compensation to its employees.

Shares of Stock of Other Corporations Owned

New York is the only state which uses the "share stock ratio," [22] although information concerning "stock of other corporations owned by the corporation" is required in the tax return to the state of Vermont.[23]

The use of the "share stock ratio" in New York has caused much controversy. In fact, after the 1917 act had been in operation for one year, the State Tax Commission recommended that this ratio be eliminated from the allocation scheme.[24] In 1918, the legislature amended this section of the law by the provision that the "stocks of other corporations owned" should not exceed ten per centum of the real and tangible personal property in the numerator or denominator of the allocation fraction. This, however, created additional complications. If a foreign corporation

[19] Income Tax Law and Regulations (1931) P. 44 f.
[20] Prentice-Hall, *State and Local Tax Service*, Vol. 7, paragraph 1231.
[21] California, Idaho, Massachusetts, Mississippi, North Dakota, Oregon, and Utah.
[22] "The value of share stock of another corporation owned by a corporation liable hereunder shall for purposes of allocation of assets be apportioned in and out of the state in accordance with the value of the physical property in and out of the state representing such share stock." *Tax Law*, Art. 9A, Sec. 214 (9).
[23] The Vermont law provides that regulations for the allocation of net income shall be left to the discretion of the commissioner of taxes. The type of information required in the tax return, however, indicates that this share stock ratio will be used. The law became effective Dec. 31, 1931 and the first returns from corporations were not due until April 15, 1932.
[24] It was contended that this type of property, when held by a business corporation, did not represent capital used in the regular course of business, but represented surplus investments. Furthermore, such holdings accounted for a relatively small percentage of the corporate income.

conducted its business chiefly through subsidiaries and received most of its income in the form of dividends on stock, it would be required to pay a tax measured by entire net income, including dividends, but the value of the stock, in excess of the ten per cent maximum, could not be included in the allocation fraction; or, if a foreign corporation invested in railroad or industrial bonds, it would be required to pay a tax measured by entire net income, including bond interest, but the value of the bonds could not be included in the segregation of assets. This inconsistency was brought to the attention of the courts in the Alpha Portland Cement case[25] and the amendment of 1918 was declared to be invalid. The court held that the "relator should be permitted to subtract from the income the item of interest on the bonds; that it should be permitted to add the value of its shares in other corporations to the value of its assets without the state." The net result of this decision was that such share stock could be included in the allocation ratio with no limitations regarding the value of real and tangible personal property.

In connection with the "share stock ratio," the treatment which is extended to investment companies should be mentioned. There is a provision in the law,[26] which authorizes the tax commission to adjust the tax in an equitable manner when the statutory segregation of assets does not properly reflect corporate activity of the business transacted in New York. Such adjustment is necessary in a great many cases for investment companies. Obviously the statutory formula will not always reflect properly their activities or income from business within the state because the physical assets which are represented by such shares of stock might be located for the most part outside of the state, and other securities, such as bonds, might be deposited outside of the state and thus according to the formula be allocable without the state. In the case of an investment company one could hardly insist that the situs of such physical assets without the state indicated the proportion in which the taxpaying company's business was without the state. In this kind of a situation it is probable that the tax commission, in determining the proportion of business attributable to New York, will consider other facts such as the "number of people employed here, amount of company's payroll in New York, its purchases and operating expenses generally in New York, in comparison to the total of these expenditures to the total number of employees within and without the state." [27]

Purchases

North Dakota is the only state that uses the item of purchases as an allocation criterion. Moreover, it is the only state that has

[25] *People ex rel. Alpha Portland Cement Company* v. *Knapp*, 230 N. Y 48. See P. 68.

[26] *Tax Law* of New York, Art. 9A, Sec. 211, subd. 117.

[27] Prentice-Hall, *New York Tax Service* (1931), paragraph 2021.

adopted the model allocation rule which was suggested by the Committee of the National Tax Association.[28] When this rule was proposed, the Committee on Apportionment pointed out "with regard to the element of purchases, it seems to the committee necessary to introduce this element, if the originating end of the business is to be properly reflected, e. g., consider the city milk industry, where the purchasing and collecting are often in one state and the sale and delivery in another; consider, also, the chain-store business, which is a combination of wholesaling and retailing. It is obvious that the entire profit should not be assigned to the retail branches, as this profit includes the wholesale profit as well as the retail profit. However, very little profit will be assigned to the head office, by consideration of the wage and salary element alone. The wholesaling profit is largely due to the centralized purchasing and may well be measured by crediting the head office with business activity to the amount of the purchases made by it." [29]

Manufacturing Costs

Four states, Wisconsin, Washington, Arkansas and North Carolina, use the ratio of manufacturing costs within and without the state as a criterion for allocating the income of manufacturing corporations. In Wisconsin and Washington the manufacturing cost ratio is weighted at one-third and in North Carolina at one-half in the allocation fraction, while in Arkansas it is the sole criterion for manufacturing companies. In Wisconsin, Washington and North Carolina, manufacturing costs including (1) total cost of all goods, materials and supplies used in manufacturing, processing or assembling within the state, regardless of where the goods were purchased; (2) total wages and salaries paid or incurred within the state—direct labor; and (3) total overhead or manufacturing burden properly assignable to such manufacturing, processing or assembling activities within the state.[30]

Business

Two states—Georgia and North Dakota—use the ratio of business within and without the state, attaching a weight of fifty per cent thereto. In North Dakota, the amount of business which is conducted within the state is measured by three factors: payroll, purchases and gross receipts. In Georgia, no measures of business activity are specified in the statute, the matter being left to the discretion of the tax commissioner.

A different approach to the business factor is illustrated in the Missouri procedure. The statute provide for the use of the gross sales ratio, but as an alternative the taxpaying corporation may

[28] See P. 62 f.

[29] "Report of the Committee on the Apportionment Between States of Taxes on Mercantile and Manufacturing Business", National Tax Association, *Proceedings* (1922), P. 207 f.

[30] Wisconsin *Statutes*, (1929) chap. 71.02 (3d 2abc).

use a combination of intrastate and interstate business. It is provided that "in cases where sales do not express the volume of business, the amount of business transacted wholly in this state shall be added to one-half of the amount of business transacted partly in this state and partly outside this state and the amount thus obtained shall be divided by the total amount of business transacted, and the net income shall be multiplied by the fraction thus obtained, to determine the proportion of income to be used to arrive at the amount of tax."[31] The factors, other than sales, which are used as measures of business conducted within and without the state are not specified in the statute; apparently the selection of such factors is left to the discretion of the tax commissioner.

Certain Accounts Receivable

New York is the only state in which certain accounts receivable are used as an allocation criterion, although information in this connection is required in the tax return to the state of Vermont. In New York, this is a composite ratio consisting of the average monthly value of accounts and bills receivable arising from (1) the sale of personal property and (2) the service performed by any officer, agent or representative of the company.[32] In the Vermont law, however, information is required only for bills and accounts receivable from sales.[33]

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[31] *Revised Statutes*, Sec. 10115 (3d).

[32] The sales ratio is explained in a previous section of this chapter, *supra*, page 8. The statute provides for a segregation of "bills and accounts receivable arising from (a) personal property sold by the corporation from merchandise manufactured by it within this state; (b) personal property owned by the corporation and not manufactured by it within this state but sold by it or its agents and located within the state at the time of the receipt of the order; (c) the purchase or sale of, or trading in, goods, wares or merchandise not located at any place at which the corporation conducted a permanent or continuous business without the state, and where the bills and accounts receivable arose from orders received or accepted by any officer or agent, or at any place of business, in this state; and (d) services performed by any officer, agent or representative of the corporation connected with, sent from, or reporting, either directly or indirectly, to any officer located in this state or at any office located, owned, rented or occupied in this state." *Tax Law* of New York, Art. 9A, Sec. 211 (4).

[33] "Bills and accounts receivable arising from (1) personal property sold by the corporation manufactured by it within the state; (2) personal property owned by the corporation and not manufactured by it within the state but sold by it or its agents and located within the state at the time of the receipt of the order." General laws of Vermont relating to income taxes, enacted by General Assembly, 1931, No. 17, Part II, Sec. 9e.

PART III

EVALUATION OF EXISTING PRACTICES

CHAPTER VII

DOUBLE TAXATION

"Double taxation in the simplest sense denotes the taxation of the same person or the same thing twice over. This is at once a very old and a very new phenomenon." [1] Double taxation arises in many different forms, all of which may be reduced to two chief categories: "that by competing jurisdictions or authorities, and that by the same jurisdiction or authority." [2] The first type has a direct bearing upon the problem of allocating corporate income, and is a result, primarily, of the extension of corporate activities beyond the jurisdiction of a single state.

Professor Seligman has stated that "almost all existing double taxation in civilized nations is due to inattention to these modern industrial intricacies";[3] this is fully substantiated in the emergence of the problem of allocating corporate income. Allocation rules have been formulated, apparently, with the intention of securing the greatest amount of revenue, regardless of the claims of other jurisdictions. If the allocation requirements of some of the states were fully enforced, it would frequently happen that corporations would be taxed on more than one hundred per cent of their income. It is the purpose in this chapter to indicate some of the causes and manifestations of double taxation as well as to point out certain remedies within the existing framework of government.

Factors Contributing to Double Taxation

RUDIMENTARY ALLOCATION CRITERIA—*Confusion of Residence and Origin Principles.*—Much confusion in allocation arises because of the combination, on an unequal basis, of the principles of *origin* and *residence*.[4] An "origin" tax[5] is one that is levied

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[1] Edwin R. A. Seligman, *Essays in Taxation* (The Macmillan Company, New York, 1928), 10th ed. Revised, P. 98.

[2] Seligman, *op. cit.*, P. 99.

[3] *Op. cit.*, P. 99.

[4] Edwin R. A. Seligman, *Double Taxation and International Fiscal Cooperation* (The MacMillan Company, New York, 1928), Pp. 89, 150. Professor Seligman states, in his critique of the reports of the Committee of Economic Experts and Committee of Technical Experts concerning the problems of double taxation for the League of Nations, that "virtually identical" conclusions were drawn by the two committees regarding "the adoption of domicile as the primary and general criterion applicable to pure income taxes [personal income tax] and its modification by consideration of origin in the case of demi-personal taxes like the situs and source taxes [American land and business or corporation taxes] and of quasi-personal taxes like the origin taxes." [French impôts cedulaires.]

[5] M. B. Carroll, *Double Taxation Relief*, U. S. Department of Commerce, Trade Information Bulletin, No. 523 (1927), P. 16.

by a state on the income of residents or non-residents arising from sources within the state. Application of the *origin* principle, as it relates to non-residents, is illustrated by the provisions in the statutes of Arkansas, Mississippi, North Carolina and South Carolina that the allocation fraction shall be used only by foreign corporations. The *residence* taxes are those which are levied by a state on the total net income, from external and internal sources, of resident or domestic corporations with no provision for allocating income within and without the state. Domestic corporations are subject to taxation on their entire net income in Arkansas, Mississippi, North Carolina and South Carolina. In using entire net income, regardless of jurisdictional source, the state disregards the problem of allocation as it relates to domestic corporations and double taxation may result. However, the tendency to double taxation may be counteracted if the state allows a credit for income taxes paid in other states; this statement is clarified through reference to specific practices. For example, no provision is made in the Mississippi statute for the crediting of income taxes paid by domestic corporations to other states; the Arkansas law permits a deduction from gross income of income taxes paid in other states; in South Carolina, a deduction is allowed for net income arising from a regular business outside the state, while North Carolina permits a credit for income taxes paid in any other state. By the refusal to grant such credits, *origin* considerations are ignored and the levy becomes essentially a *residence* tax. No objection is advanced against the practices of North Carolina and South Carolina inasmuch as each state allows a full credit, or its equivalent, for income taxes paid in other states, the result being practically the same as if the allocation fraction were applicable to both foreign and domestic corporations. On the other hand, the failure of Arkansas and Mississippi to allow full credit for income taxes paid in other states represents a rudimentary concept of allocation and, as noted previously, may lead to double taxation.

Inadequate Criteria for Localization of Income.—Double taxation may arise from a perversion of the *origin* principle through the failure of certain states to adopt adequate criteria for determining the situs of income arising from sources in several states. The requirement in Connecticut that manufacturing corporations use the property ratio in apportioning income is based on the assumption that the physical situs of property coincides with, and determines, the economic location of income. According to the Tennessee and Missouri practice, it is assumed that the situs of taxable income coincides with the situs of the sale.[6] If a corporation were engaged in manufacturing in the state of Connecticut and transacted most of its sales in Tennessee, the application of the respective allocation fractions would result in the taxation

[6] The questions involved in determining the situs of a sale are discussed at P. 94. See also Pp. 82–85.

of more than one hundred per cent of the corporation's net income.[7]

Dual Fractions.—Similarly, the use of the dual-fraction[8] or separate fractions for mercantile and manufacturing corporations respectively, may contribute to double taxation.[9] If a corporation were operating in two states that use the dual-fraction, the result from the standpoint of allocation, would be quite similar to the case described above of a corporation operating in Connecticut and Tennessee.

MULTIPLICITY OF ALLOCATION RATIOS.—The multiplicity of allocation ratios is the greatest source of friction in the distribution of taxable income among the states. It was shown in a previous section[10] that ten different bases of apportionment are employed by the states, while weights, ranging from zero to one hundred per cent, are attached to some of these various bases. In general, there are no less than twelve different allocation fractions in use.[11] Under such circumstances, double taxation is almost unavoidable and particularly if the rules are rigidly applied. It was shown above that if a corporation were operating in Connecticut and Tennessee, the application of the property ratio and sales ratio might lead to taxation of one hundred sixty-three per cent of the net income.[12] Similarly, if a corporation were operating in Massachusetts and Connecticut, or in any states which do not follow the same allo-

[7] The following illustration represents the proportion of taxable income that might be claimed by Connecticut and Tennessee, if the fractions were applied rigidly:

State	*Property*	*Gross receipts*	*Allocation criteria*	*Approximate percentage of taxable income*
Connecticut	$5,000,000	$1,000,000	Property	83.33
Tennessee	1,000,000	4,000,000	Gross receipts	80.0
				163.33
	$6,000,000	$5,000,000		

[8] There is a distinction between the dual fraction and the so-called alternative fraction, the latter denoting the practice of allowing the taxpayer to submit an alternative fraction for income apportionment if it can be shown that the statutory fraction is inequitable and discriminatory.

[9] In Connecticut, manufacturing corporations are required to use the property fraction while selling corporations use the gross receipts fraction. In Mississippi, manufacturing corporations use a fraction consisting of the payroll and "cost value of physical assets" ratios, while selling corporations use the net cost of sales" ratio. According to the Arkansas practice, manufacturing companies use the cost of production ratio and selling companies use the sales ratio. In North Carolina, a less objectionable form of dual-fraction was adopted recently, which consists of the combined property and manufacturing cost ratios for manufacturing companies and the combined property and sales ratios for selling companies.

[10] Chapter 6, Table 1.

[11] See P. 101.

[12] P. 92.

cation rules, it is probable that the tax would be measured by more than one hundred per cent of the income.[13]

CONFLICTING INTERPRETATIONS OF INTRASTATE SALES.—There are fifteen states which use gross receipts or sales as the sole or as a partial allocation criterion.[14] However, this does not establish a condition of uniformity, even within these fifteen states, because conflicting interpretations lead to much confusion in the distinction between intrastate and interstate sales. There are many overlapping jurisdictional claims to sales. Several states include, in the numerator of the allocation fraction, certain sales which would seem to belong properly in the denominator of the fraction, that is, in the category of interstate sales. For instance, it may be contended that sales should be allocated to (1) the state in which the goods were delivered, or (2) the state in which the contract of sale was made, or (3) the state in which the contract of sale was sanctioned. In three states—New York, Vermont and Virginia—the term intrastate sales is construed to include (1) the sale of goods within the state, wherever manufactured, and (2) the sale of goods manufactured within the state, wherever sold.[15] The result of such interpretations is the taxation of the same sales in two or more states, or rather the assignment of the same sales to several different jurisdictions for allocation purposes. For instance, let it be assumed that the products of a corporation are manufactured in New York and stored in Vermont preceding a later sale in Virginia, while the order underlying the sale is placed with the Vermont storage plant. The sale could be allocated to New York because it represented "personal property sold by the corporation from merchandise manufactured by it within the state;" Vermont would have a claim because it was a sale of "personal property owned by the corporation and not manufactured by it within this state, but sold by it or its agents and located within the state at the time of the receipt of the order," and Virginia would claim the sale under

[13] This tendency is indicated in the following illustration:

State	*Property*	*Payroll*	*Gross receipts*	*Allocation factors*	*Approximate percentage of taxable income*
Connecticut	$5,000,000	$3,000,000	$1,000,000	Property	62.5
Massachusetts ..	2,000,000	1,000,000	5,000,000	Property, payroll and gross receipts	33.5
Tennessee	1,000,000	1,000,000	3,000,000	Gross receipts	33.5
	$8,000,000	$5,000,000	$9,000,000		129.5

[14] See Pp. 82 ff.

[15] In New York, the Form for Return of Corporate Income provides that bills and accounts receivable which are allocable to New York include those arising from sales in other states where the corporation does not maintain a permanent or continuous place of business and where such sale is reported back and accepted at an office of the corporation located in New York.

the provision that sales in Virginia are allocable to the state "regardless of where the goods are manufactured."

Many of the state officials declare that the greatest difficulty in the application of an allocation fraction arise out of the interpretation of the sales ratio.[16] This is almost self-evident, because the fraction and statutory provisions relating thereto are designed to cover the majority of corporations. There are many borderline cases in the determination of the situs of sales which are difficult to settle without some centralized administration of the income tax. However the situation would be greatly alleviated by the uniform adoption of a single rule such as that of New York, which provides that the sale shall be reported to and accepted at an office of the corporation located in New York in order for it to be allocable to that state.[17]

Furthermore, the New York principle seems to be in accordance with that enunciated by the federal government.[18]

CONFLICTING INTERPRETATIONS OF THE SOURCE OF INCOME—*Possessions of the United States.*—Several years ago a very interesting problem in double taxation arose between the United States and Puerto Rico because of conflicting interpretations regarding the source of taxable income. This problem was explained in connection with the methods of allocation employed by the federal government,[19] but additional reference to it should be made at this

[16] "So many diverse methods of contract are employed in the selling department of a business that many perplexing problems arise when it comes to assign or identify a sale with a given branch office or agency. Border line cases must always be determined on the circumstances and merits of each case, as no uniform rule could be adopted which would fit all cases coming under this category." Letter from Commissioner W. J. Conway, of Wisconsin to the writer, under date of August 17, 1931.

[17] See note 15, *supra*.

[18] "There is considerable diversity in the judicial decisions respecting what is the sale and accordingly respecting what is the place of sale. The only reconciling principle to be deducted from the decisions is that the act or event having the most cogent relationship to the legal issue presented for resolution in a particular field is deemed the sale and the place where that act or event occurs is deemed the place of sale. Thus, in the field of constitutional law, where the jurisdiction of the United States or one of its constituent states is in question, the substance of the sale is deemed the contract between the seller and buyer under which the property in the goods is either presently or ultimately transferred. Thus, in *Norfolk and Western Railway Company* v. *Sims* (191 U. S. 441, 447), the Supreme Court of the United States said: A sale really consists of two separate and distinct elements: first, a contract sale . . . and second a delivery of the property, which may precede, be accompanied by, or follow the payment of the price . . . The substance of the sale is the agreement to sell and its acceptance."

"The decision [*Compania General de Tobacos de Filipinos* v. *Collector*] (279 U. S. 306) is conclusive that the technical rules as to the passing of the property in the goods and the assumption of risk are not determinative of the place of sale and the source of income from the sale of goods. The essential character of the transaction—the contract of sale—is the decisive factor in determining the place of sale for the purpose of determining the source of income." Quoted in Prentice-Hall, Inc. *Federal Tax Service* (1931), Pp. 180–185.

[19] P. 64 f.

point. Certain selling companies in the United States maintained establishments in Puerto Rico for the purchase of tobacco and molasses. The profits of such companies were taxable in the United States on the theory that income originates in the country in which the goods are sold; while Puerto Rico taxed the profits on the theory that the income from the sale of Puerto Rican products, wherever sold, was taxable by Puerto Rico. Consequently, these concerns were taxable on approximately two hundred per cent of the net income. The manner in which this problem was settled by the two Governments, upon the recommendations of Professor Haig, is explained in the reference cited above.

International.—The solution to the Puerto Rican problem is not applicable to a company which operates, under similar conditions, in a foreign country.[20] An interesting case is described in the Carroll report.[21]

> Where foreign countries levy a tax on the purchase in their territory of goods which are sold in the United States, double taxation results, from which there may be no relief. [This is caused by the American practice according to which all of the income from the sale, in the United States, of goods that were purchased in another country is attributable to this country.] For example, an American taxpayer paid income tax in India on the basis of profit arbitrarily ascribed to the purchase there of raw materials which were subsequently sold in the United States. The Board of Tax Appeals held that such levy was an income tax which could be credited against the United States tax unless precluded by the limitation which, in substance, reads that the credit may not exceed the same proportion of the tax against which such credit is taken which the taxpayer's net income from sources without the United States bears to his entire net income from the same taxable year (1926 Act, Sec. 238 (a); 1928 Act, Sec. 131 (b)).
>
> There was no income from sources without the United States, however, as the entire income from the purchase of goods without and their sale within the United States is deemed by law to arise in the United States (1926 Act, Sec. 217 (e); 1928 Act, Sec. 119 (e)). Consequently, double taxation resulted from the imposition of the Indian tax on a presumed profit from the purchase in India and of the United States tax on the real profit, derived from the sale in its territory. As the Revenue Act treated the income as derived from a United States source, no credit could be taken against the American tax for the Indian tax. The foreign tax could only be deducted from the taxpayer's gross income (Burk Brothers v. Commissioner, September 4th, 1930, 20 B. T. A. 657).[22]

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[20] The allocation fraction for this type of enterprise is described at P. 64.

[21] "Tax System and Allocation Methods in the United States of America." *Taxation of Foreign and National Enterprises*, League of Nations (1932), P. 253.

[22] Another phase of this problem, as described in the Carroll report, relates to the question regarding "whether profits have actually been derived. For example, a foreign enterprise which has an establishment within one of those countries (France, Germany or Spain) for the purpose of buying raw materials is subject to tax, even though the materials are immediately exported and used or sold by establishments of the enterprise in other countries. Under the laws of Great Britain or the United States, however, income must really have been derived or accrued, for example, from the sale of goods or services. Consequently, a foreign enterprise can have a permanent establishment in either Great Britain or the United States without being subject to income tax because of the fact that the establishment neither manufactures nor sells goods, nor renders services to third parties for remuneration." *Op. cit.*, P. 23.

Elimination of Objectionable Double Taxation

The elimination of objectionable double taxation is dependent upon: (1) agreement on fundamental principles underlying a proper allocation and (2) adoption of a uniform procedure. This applies to both the interstate and international problems, although there is some difference of technique to be followed in the two cases. In international practice, there is a decided preference in favor of separate accounting, the method of fractional apportionment being used as a last resort.[23] But even with separate accounting it is necessary to reach an agreement regarding the principles to be applied in determining the source of income, if double taxation is to be avoided. For example, the contention that entire net income is taxable in the country in which the goods are sold may conflict with and overlap the claims of other countries which levy a substantial tax on purchasing establishments. All of these matters should be taken into consideration in allocating income among the branches of an enterprise which operates in several countries and the test to be applied should be that of determining what would be the profit if each branch were an independent concern.[24]

The question of international double taxation is beyond the scope of this investigation, but reference should be made to two very significant developments. At the present time, a bi-lateral treaty for the elimination of double taxation between the United States and France is dependent only upon ratification by the latter country. If ratified, it will entail the renunciation by both countries of the right to impose income taxes on business enterprises of the other country except on the profits of a branch within the country. Second, the Fiscal Committee of the League of Nations has undertaken an investigation of international allocation practices, the results of which will serve as a basis of a multi-lateral treaty for the elimination of objectionable double taxation.[25]

The elimination of interstate double taxation, of an objectionable character, involves a choice between ameliorative and fundamental reforms, and there are strong presumptions in favor of the latter type. As analysis of the allocation problem proceeds, it becomes increasingly evident that basic changes must be made in governmental relationships for the achievement of fundamental reforms. Consideration of this question, however, is reserved for another section.[26] Attention here is confined to two proposals which are of an ameliorative character although entailing action on the part of Congress and the United States Supreme Court. They would not provide a full solution because so many existing problems would remain untouched in the application of these

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[23] See P. 35 f.

[24] Many obstacles confront the full application of this test. See P. 115.

[25] See P. 113.

[26] Chapter X.

devices. The objections to such methods are stated in the final section which deals with the methods of accomplishing uniformity.[27]

In the first place, the Supreme Court might formulate a few simple rules for the prevention of double taxation arising out of allocation of corporate income among the states, as it has done in the case of inheritance taxation.[28] Such rules should relate to the selection of uniform criteria, the determination of the situs of sales, methods of evaluating property and the distinction between intrastate and interstate commerce.

This, however, is dependent on taxpayers presenting to the courts the issue of double taxation arising out of overlapping allocation devices. Thus far, the allocation cases have turned mainly on the question of whether or not the application of a certain fraction operated in an unreasonable and discriminatory fashion and resulted in the apportionment of an unduly large proportion of the entire net income to a single state. It remains for some large corporate taxpayer operating in several states to prove to the courts that the combined application of several fractions results in the taxation of more than one hundred per cent of the corporate net income. Then, the Supreme Court will have an opportunity to enunciate principles for eliminating competitive allocation and consequent double taxation in a manner comparable to its action in meeting problems arising out of overlapping taxes on inheritance.

A different type of solution was proposed by Mr. W. S. Elliott in an address before the National Tax Association.[29] If Congress would enact legislation of the type which he suggests, it would offer a much more effective basis for action by the Supreme Court than is afforded by the preceding proposal. The proposed legislation is quoted in entirety:

> Whereas many states have adopted income tax laws and are using various inconsistent formulae for fractional apportionment of total income of corporations and individuals doing business within and without the state, as a result of which the same income is taxed in more than one state, and interstate commerce is unduly burdened,
>
> Be It Enacted, that no state shall impose any income tax or license tax based upon or measured by income arising from transactions of interstate commerce conducted partly within and partly without said state unless the portion of said income subjected to taxation is determined and set apart by methods of allocation and apportionment approved by the Commission created by this Act. The Commission shall prescribe such rules and methods of allocation and apportionment of income derived from interstate and foreign commerce as in its judgment will avoid double taxation and permit each state to tax the portion thereof reasonably attributable to business conducted within its borders.

[27] See chapter X.

[28] The legal principles and rules for the prevention of double taxation of inheritance were developed and applied in a series of cases: *Farmers Loan and Trust Company* v. *Minnesota*, 280 U. S. 204 (1930); *Baldwin* v. *Missouri*, 282 U. S. 586 (1930); *Beidler* v. *South Carolina Tax Commission*, 281 U. S. 1 (1930); *First National Bank of Boston* v. *State of Maine*, 284 U. S. 312 (1932).

[29] National Tax Association, *Proceedings* (1932).

Mr. Elliott concludes with the observation that "it is for Congress to say what is an undue burden on interstate commerce and when Congress breaks its silence, the Supreme Court will accept its views."[30]

[30] For further consideration of this proposal, see P. 118.

CHAPTER VIII

THE PRESENT STATUS OF UNIFORMITY IN ALLOCATION PRACTICES

Meaning of Uniformity

Absolute uniformity and equality in taxation is unattainable. Uniformity must be viewed as a relative concept and it denotes simply the abandonment of varied and dissimilar allocation bases by the states. It does not imply the rigid application of identical allocation formulae, or the adoption necessarily of uniform tax rates. Some states require a greater revenue per unit of taxable value than other states, which leads to diversity of tax rates. However, in the case of the allocation formula, it is desirable that a uniform rule be adopted, but there should be a flexible provision in the law permitting a relaxation of the requirements in exceptional cases. Special criteria could be prescribed or permitted in such cases and the use of separate accounting allowed if the company records were adequate for segregating income by jurisdictions.

The test of uniformity lies in the equalization of the burden on various tax bases and the adoption of allocation criteria for the distribution of not more than one hundred per cent of corporate income among the taxing units. The most that can be anticipated is an approximate and relative uniformity which will displace the existing chaotic situation.

Desirability of Uniformity

The desirability of some degree of uniformity is evident from much of the preceding material and, particularly, that which dealt with double taxation. The probability of multiple taxation is enhanced because of the use of ten different bases of allocation. If the states were willing to cooperate, they could select three or four of these bases for uniform application, scrapping the others, and many of the present inequities would be eliminated. The problem of fractional apportionment is not so much the superiority of one criterion over another, as it is the uniform adoption of a few simple rules. A few years ago, a Committee of the National Tax Association stated that:

> from the standpoint of the taxpayer, uniformity between states is by all odds the most essential requisite. It might make little difference to the taxpayer whether he is taxed on seventy-five per cent of his income at the place of manufacture and twenty-five per cent at the place of sale, or *vice versa*, so long as he is taxed only on one hundred per cent altogether. The fairest apportionment rule conceivable would be of little help to the taxpayer if only one state adopted it and the others continued to use a different rule. . . . . . All methods of apportionment of trading profits are arbitrary — the cutting of the Gordian knot . . . . . There is no one right rule of apportionment, notwithstanding that there probably are a number of different rules, all of which may work substantial justice. For the present purposes the only right rule of procedure is a rule on which the several states can and will get together as a matter of comity. Getting together by the uniform adoption of some equitable method and finding the right rule of apportionment are, in our opinion, synonymous.[1]

Present Status[2]

The general status of uniformity in allocation practices is shown in Table II. There are twelve of the twenty-one states that show some tendency toward uniformity, but this is not highly significant inasmuch as they use four different allocation methods. According to the Vermont practice the return of information, which is required from the taxpayer, is essentially the same as that of New York. The methods that are followed in North Carolina and Washington are similar to the Wisconsin procedure. The statutes of North Dakota and Georgia provide that income shall be apportioned on the basis of property and business, although the criteria, by which the business factor shall be measured, are not specified in the Georgia law. The strongest trend toward the adoption of a uniform procedure is represented by the group of five states—Massachusetts, California, Oregon, Utah and Idaho—which use a combination of property, payroll and gross receipts as allocation criteria. Utah, Oregon and Idaho follow a procedure very similar to the California method, which in turn is based upon the Massachusetts plan. This is the most constructive attempt that has been made to abandon dissimilar allocation practices, for which credit is due chiefly to the states on the Pacific Coast.

In the other eight states listed in Table II excluding Oklahoma, there are practically eight different methods of apportionment. Some similarity exists between the Missouri, Tennessee and South Carolina formulae, but the differences preclude classification within a single category.[3]

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[1] "Report of the Committee on the Apportionment between States of Taxes on Mercantile and Manufacturing Business," National Tax Association, *Proceedings* (1922), P. 201 f.

[2] A substantial portion of the material presented in the remainder of this chapter was published in the *Bulletin* of the National Tax Association (January 1932), "The Status and Certain Tests of Uniformity in Allocating Corporate Income."

[3] Both Missouri and Tennessee require an allocation on the basis of gross sales, but Missouri includes one-half of the sales that are partly within and without the state in the numerator of the allocation fraction. See p. 83. In South Carolina, the gross sales ratio is used when the corporation owns no real property within the state, or when the foreign corporation is engaged in buying and selling. The Mississippi method is based on net cost of sales.

TABLE II

THE STATUS OF UNIFORMITY IN ALLOCATION PRACTICES [a]

Property, payroll, gross receipts	Property and business	Segregation of assets	Property, manufacturing costs, sales
California Idaho Massachusetts Oregon Utah	Georgia North Dakota	New York Vermont	Wisconsin North Carolina Washington

a Dissimilar or non-uniform practices prevail in the following states: Arkansas, Connecticut, Mississippi, Missouri, Montana, South Carolina, Virginia, and Tennessee.
No definite method has yet been adopted by Oklahoma.

Certain Tests of Uniformity

In order to present a more definite picture of various allocation practices a set of hypothetical illustrations has been developed, in which the uniform application of certain formulae is compared with the application of varying formulae to the same corporation. Obviously, if a uniform fraction is followed, the taxpaying corporation will be assessed on approximately one hundred per cent of its net income. However, the proportions of taxable income attributable to the different states will vary according to the factors which are used in the allocation fraction.

The first illustration, as shown in Table III, is based upon relatively simple conditions in which a corporation has most of its manufacturing equipment in Connecticut, the greater portion of its sales being made in other states. The same figures are used throughout the illustrations, although only two states are considered in Case I. Case I shows the absurd result that may follow the application of allocation fractions which consist of only one ratio. The proportion taxable by Connecticut is determined by the ratio of real and tangible personal property within the state to the total of such property wherever located, while the proportion taxable by Tennessee is determined by the ratio of gross receipts within the state to total gross receipts. Under the conditions assumed, if a corporation were engaged in business in Connecticut and Tennessee it would be taxable on one hundred and sixty-three per cent of it net income. Case II indicates some improvement over the preceding illustration. Here, it is assumed that a corporation is engaged in manufacturing and selling in three states, its property, payroll and sales being distributed among the states as indicated in the respective columns. The following ratios are used in determining the proportion of income that is taxable in each state: the property ratio is applied for Connecticut; Massachusetts uses a fraction which consists of the

ratios of property, payroll and gross receipts within the state to the total of such items; the gross receipts ratio is used in Tennessee. Under the conditions assumed, the corporation would be subject to taxation on one hundred twenty-nine per cent of its income, the Connecticut proportion amounting to almost one-half of the total. In this illustration, it is shown that the effects of the Connecticut and Tennessee practices, as based upon property and sales respectively, are modified somewhat by the application of the Massachusetts method which combines property and sales with the payroll ratio. It is interesting to carry the assumption one step further and apply the same ratio in determining the

TABLE III

CASE I: APPLICATION OF VARYING FORMULA

STATE	Property	Gross receipts	Allocation factors	Approximate percentage of taxable income
Connecticut	$5,000,000	$1,000,000	Property	83.33
Tennessee	1,000,000	4,000,000	Gross receipts	80.0
	$6,000,000	$5,000,000		163.33

CASE II: APPLICATION OF VARYING FORMULAE

STATE	Property	Payroll	Gross receipts	Allocation factors	
Connecticut	$5,000,000	$3,000,000	$1,000,000	Property	62.5
Massachusetts	2,000,000	1,000,000	5,000,000	Property, payroll and gross receipts	33.5
Tennessee	1,000,000	1,000,000	3,000,000	Gross receipts	33.5
	$8,000,000	$5,000,000	$9,000,000		129.5

CASE III: UNIFORM APPLICATION OF CONNECTICUT FORMULA

STATE	Property	Payroll	Gross receipts	Allocation factors	
Connecticut	Same as in Case II			Property	62.5
Massachusetts				Property	25.0
Tennessee				Property	12.5
					100.0

CASE IV: UNIFORM APPLICATION OF TENNESSEE FORMULA

STATE	Property	Payroll	Gross receipts	Allocation factors	
Connecticut	Same as in Case II			Gross receipts	11.11
Massachusetts				Gross receipts	55.55
Tennessee				Gross receipts	33.33
					99.99

CASE V: UNIFORM APPLICATION OF MASSACHUSETTS FORMULA

STATE	Property	Payroll	Gross receipts	Allocation factors	
Connecticut	Same as in Case II			Property, payroll and gross receipts	44.54
Massachusetts					33.52
Tennessee					21.94
					100.00

proportion of income taxable in each of the three states, conditions remaining the same—Cases III-V. In Case III, the property ratio is applied by the three states. The corporation is taxable on one hundred per cent of its income, the Connecticut proportion amounting to approximately sixty-two per cent. In Case IV, when the gross receipts ratio is applied, the corporation is again taxable on approximately one hundred per cent, but the Connecticut proportion declines to eleven per cent while the Massachusetts proportion is increased to fifty-five per cent. In Case V, the Massachusetts fraction is applied uniformly in the three states. The results in this case indicate a more equitable distribution of taxable income among the three states, even though the Connecticut and Tennessee proportions are eighteen per cent and eleven per cent less, respectively, than when their own methods are followed. This solution will repay consideration because it is a crude presentation of the goal that is to be achieved through the use of a uniform allocation rule.

Of the four different methods in use among those states which show even a remote tendency toward uniformity, the Massachusetts and North Dakota fractions alone appear to possess characteristics that would be suitable for widespread adoption. For that reason, the emphasis in the illustrations shown in Table IV is centered upon these two methods, although from this inadequate test it could not be contended that one is superior to the other. Nevertheless, it seems that, if the method of fractional apportionment is to be the prevailing mode, either fraction would serve the purpose adequately.

The set of cases which are shown in Table IV illustrates more clearly the results that would follow if certain fractions were applied uniformly. Here it is assumed that a corporation is engaged in business in four states; about half of its products are manufactured in Connecticut; some manufacturing is done in the other states; the sales are distributed among the states as shown in the gross receipts column. The proportion of income which is taxable in each state, according to the different allocation fractions, is indicated in the last column.[4] Obviously, these proportions will vary according to the ratios which are included in the fraction. The purpose of the illustration is to compare the proportions of income that are taxable in each state when (1) the allocation fractions of the four states are applied simultaneously to the income of the corporation—Case I, and (2) when each separate fraction is applied uniformly by the four states—Cases II-VI.

[4] In each case the proportion of taxable income was determined by setting up the ratios of property, payroll, purchases and gross receipts within the state to the total of such items; the resulting proportions were averaged arithmetically and translated to percentages. The allocation fractions of the various states are shown more clearly in the Appendix to the report.

TABLE IV

CASE I: APPLICATION OF VARYING FORMULAE

STATE	Property	Payroll	Purchases	Gross receipts	Allocation factors	Percentage of taxable income
Massachusetts....	$2,000,000	$3,000,000	$1,000,000	$4,000,000	Property, payroll and gross receipts......	32.804
Connecticut......	4,000,000	1,000,000	1,000,000	2,000,000	Property............	44.444
North Dakota....	2,000,000	2,000,000	1,000,000	3,000,000	Property and business	24.206
Virginia..........	1,000,000	1,000,000	1,000,000	3,000,000	Property and gross receipts...........	18.055
	$9,000,000	$7,000,000	$4,000,000	$12,000,000		119.509

CASE II: UNIFORM APPLICATION OF CONNECTICUT FORMULA

STATE	Property	Payroll	Purchases	Gross receipts	Allocation factors	
Massachusetts....	Same as in Case I................................				Property............	22.222
Connecticut......					Property............	44.444
North Dakota....					Property............	22.222
Virginia..........					Property............	11.111
						99.999

CASE III: UNIFORM APPLICATION OF TENNESSEE FORMULA

STATE	Property	Payroll	Purchases	Gross receipts	Allocation factors	
Massachusetts....	Same as in Case I................................				Gross receipts........	33.333
Connecticut......					Gross receipts........	16.666
North Dakota....					Gross receipts........	25.0
Virginia..........					Gross receipts........	25.0
						99.999

CASE IV: UNIFORM APPLICATION OF VIRGINIA FORMULA

STATE	Property	Payroll	Purchases	Gross receipts	Allocation factors	
Massachusetts....	Same as in Case I............................				Property and gross receipts	27.777
Connecticut......					Property and gross receipts	30.555
North Dakota....					Property and gross receipts	23.611
Virginia..........					Property and gross receipts	18.055
						99.998

CASE V: UNIFORM APPLICATION OF MASSACHUSETTS FORMULA

STATE	Property	Payroll	Purchase	Gross receipts	Allocation factors	
Massachusetts....	Same as in Case I....................				Property, payroll and gross receipts	32.8042
Connecticut......					Property, payroll and gross receipts	25.1322
North Dakota....					Property, payroll and gross receipts	25.2645
Virginia..........					Property, payroll and gross receipts	16.7989
						99.9998

CASE VI: UNIFORM APPLICATION OF NORTH DAKOTA FORMULA

STATE	Property	Payroll	Purchases	Gross receipts	Allocation factors	
Massachusetts....	Same as in Case I................................				Property and business.	27.97615
Connecticut......					Propertyand business.	31.546715
North Dakota....					Property and business.	24.206345
Virginia..........					Property and business	16.26984
						99.99005

In Case I, it is shown that when a corporation, operating in the four states under the assumed conditions, is required to use the allocation fraction in each state it will be subject to taxation on approximately 119 per cent of its income. Obviously, when each fraction is taken separately and applied uniformly by the four states, the corporation will be taxed on one hundred per cent of its income. However, the crux of the matter is the proportions that will be taxable by each state when different ratios are applied. Using Connecticut as an example of this test, it is shown that under the property ratio—Case II—44.5 per cent of the taxable income is allocable to this state; on the gross receipts basis—Case III—Connecticut may tax 16.7 per cent of the income; a combination of property and gross receipts weighted at fifty per cent each—Case IV—shows 30.5 per cent attributable to her; with property, payroll and gross receipts weighted at one-third each—Case V—as in the Massachusetts formula, approximately twenty-five per cent arises from sources within the state; and when property and business are weighted equally, as in North Dakota—Case VI—the results show 31.5 per cent that are taxable by Connecticut. The same procedure may be followed for each of the other states. An interesting result of this set of illustrations is that the relative positions of the four states remain unchanged in Cases I and VI, i.e. when each state uses its particular fraction and when the North Dakota method is applied. According to the assumed conditions there is an absolute tax reduction due to a shrinkage in the base to approximately one hundred per cent of the corporate income, but the relative positions of the states is unchanged.

Fairly equitable allocation under existing standards may occur accidentally or through the exercise of much administrative discretion, but it is just as plausible, and even more probable, that unequal practices produce unfair results.

Methods of Achieving Uniformity

The question arises naturally at this stage of the inquiry as to what method should be followed in achieving uniformity in state practices. However, the matter is so much involved in the conclusions of the investigation that it seems advisable to postpone consideration until the final chapter.

PART IV

TOWARD UNIFORMITY

CHAPTER IX

PROPOSALS FOR THE SOLUTION OF THE PROBLEM

The proposals which have been made for the solution of the allocation problem may be placed in two categories, both of which are predicated upon the adoption of a uniform rule. Classification and separate treatment are essential because the methods of accomplishing uniformity are so radically different. Within one category are included the plans which have been suggested for voluntary adoption, presumably by means of interstate agreements. Three proposals have been made in this connection: (a) the proposal by a committee of the National Tax Association for a model allocation fraction;[1] (b) a plan for apportionment of income according to expenses incurred in each state;[2] and (c) the method of separate accounting.

The other type is based upon the assumption that reciprocal and voluntary agreements are practically unattainable so that any real reform must be accomplished by means of a functional reorganization of governmental relationships, with the federal government assuming the initiative in the development of a uniform procedure. Consideration of this proposal is reserved for the next chapter. While it is recognized that any one of the three proposals considered in this section might be applicable under either method of voluntary or compulsory uniformity, they are considered under the former because they were not originally proposed as part of a larger plan of governmental reorganization.

Model Allocation Fraction

The essential features of the proposal of the Committee of the National Tax Association were described in a previous section.[3] The principles upon which the formula is based may be summarized as follows: (a) certain elements of income are non-apportionable; (b) the allocation of income from mercantile and manufacturing activities is predicated upon the two factors of property and business; and (c) an omnibus provision is included that allows the tax-paying corporation to file its return under an alternative method in case the original formula leads to inequitable results.

In the report of the Committee on the Apportionment between States of Taxes on Mercantile and Manufacturing Business, it was pointed out that both property and business should be used

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[1] National Tax Association, *Proceedings* (1922), P. 198 *et seq.*

[2] "Elimination of Double Taxation of Corporate Net Income." (1930) 8 *National Tax Magazine* 329.

[3] See P. 62 f.

as allocation criteria because manufacturing and selling activities involve two chief elements, namely: the investment of capital in tangible property and the turnover of goods, materials and labor. Moreover, the inclusion of both factors is in accordance with leading legislative tendencies.

In measuring the property factor, only tangible property—real and personal— should be included. Several reasons were offered in support of the exclusion of intangible property: "first, the practical difficulty of assigning a geographical situs to intangibles; second, the fact that there is a marked legislative tendency to eliminate intangibles, which tendency it seems necessary to take into account; third, it seems possible to make a fair apportionment without consideration of intangibles. . . . Investments yielding interest and dividends should be left out of the formula in any event, as these items of income are no part of the trading or net business profit to which the formula should be applied. Interest and dividends can and should be allocated specifically."[4]

Regarding the business factor the recommendation was made that it be measured by the amounts paid out for labor and material plus the receipts from the sale of goods, that is, the measure would include both income and outgo. The reasoning of the Committee is that two turnovers are involved in the production of profit; the investment of the working capital and the conversion of such investment into money through sales. The creation of net income is as much a result of efficient manufacturing and purchasing as of efficient selling. Regarding the item of expenditures, the outlays for labor and materials do not represent the entire outgo of manufacturing or selling companies, but most of the expenditures are incurred for these purposes.

"With regard to the element of purchases, it seems to the committee necessary to introduce this element, if the originating end of the business is to be properly reflected. For example, consider the city milk industry, where the purchasing and collecting are often in one state and the sale and delivery in another; consider, also, the chain-store business, which is a combination of wholesaling and retailing. It is obvious that the entire profit should not be assigned to the retail branches, as this profit includes the wholesale profit as well as the retail profit. However, very little profit will be assigned to the head office, by consideration of the wage and salary element alone. The wholesaling profit is largely due to the centralized purchasing and may well be measured by crediting the head office with business activity to the amount of the purchases made by it."[5]

It should be noted, however, that a later committee expressed certain doubts regarding the inclusion of the purchases item. "The bill reported by that committee [1922] contained a provision that the allocation fraction could be supplanted by some

[4] *Proceedings* (1922), P. 205.
[5] *Ibid.*, P. 207 f.

other method of apportionment, if the taxpayer were successful in his 'petition for determination of his income on some other basis.' Very good reasons were assigned for restricting this relief provision to the taxpayer; if, however, it had been granted as well to the state, then purchases could have been left out of the fraction except in the cases that are perhaps exceptions and are similar to the two cases cited of the city milk industry and the chain store. In such cases, the tax administrator could build up a fraction including purchases; but for the vast majority of businesses, the job of allocating income would be greatly simplified if the item of purchases were eliminated from the allocation fraction."[6]

The exclusion of purchases as a criterion of business activity, would create a resemblance to the Massachusetts rule in that both fractions would be based on the factors of property, payroll and sales. However, the weighting would be different. According to the Massachusetts method, each factor is weighted equally, that is at one-third; while, under the revised method of the Committee, property and business are weighted at fifty per cent each,[7] the business factor being measured by payroll and sales. The differences between the two methods are not great, and it would be but a short step for the Committee if it should decide to throw its full support to the Massachusetts rule. The original proposal for a model fraction was intended as a compromise over existing practices that would expedite the movement toward uniformity. It will be recalled that greater emphasis was placed by the Committee on the achievement of uniformity than on any particular rule for uniform adoption, despite its recommendation for a model fraction. Furthermore, there are at present four states which use an allocation rule bearing close resemblance to the Massachusetts method. In view of these circumstances, and if uniformity is the primary objective, it would seem advisable for the committee of the National Tax Association to give full support to the Massachusetts rule as a model for uniform adoption.

Apportionment According to Expenses

Another type of solution for uniform adoption involves an apportionment of income according to the expenses which are incurred in each state.[8] The proportion of taxable income in each state would be determined by the ratio of expenses incurred in the state to total expenses, in which would be included a translation of the capital investment into equivalent annual charges at the rate of

[6] *Proceedings* (1929), P. 158.
[7] Equal weights were assigned to the two factors, because: (a) it is a "fair basis of compromise" between those states which would gain most by attaching great weight to property and those states which would prefer the emphasis being placed on sales; (b) in considering investment yields, "property alone will yield five to six per cent; property plus business, ten to twelve per cent; therefore, on the average, each factor is responsible for half the income." *Proceedings* (1922), P. 205.
[8] See Note 2, *supra*.

six per cent or whatever was the standard rate of interest. The reduction of fixed capital investment to the common denominator of equivalent annual charges is an essential part of the plan; it would be based on the actual fair cash value of fixed capital, exclusive of that which is covered by interest-bearing debt.

This proposal is based on the concept that affiliated or associated concerns constitute a single unit and should not be segregated into profitable and unprofitable concerns.[9] If the business as a whole shows a loss during the year, no unit or branch which shows a profit should be subject to a tax. On the other hand, if the business as a whole shows a profit during the year, then an unprofitable unit in another jurisdiction should be taxed on a pro-rata share of the total net income as determined by the ratio which the annual expense of the unprofitable unit bears to the total annual expenses of the enterprise. To this end, a consolidated return would be required from all groups of affiliated concerns. In case of any relaxation of this requirement, the burden of proving that the affiliated concerns should be treated as separate units should rest upon the business and not upon the government.

If this plan were adopted by all of the states, it would achieve the desired result of eliminating the taxation of more than one hundred per cent of corporate income. There are, however, certain objections which might be raised concerning (a) the full application of the unit rule and (b) the difficulty of administration.

In the first place, if the unit rule were applied fully it would mean that a profitable subsidiary of an enterprise which operated at a loss would not be subject to an income tax in the state in which it operated. Legally, the state has the power to tax such income and it is very improbable that this power would be relinquished voluntarily. On the other hand, the adoption of this method involves certain compensatory features for the taxing authority insofar as an unprofitable subsidiary of a profitable enterprise would be subject to taxation on its pro-rata share of the net income as determined by expenses incurred within a particular state. However, the state would probably contend that any compensatory features would be temporary because an unprofitable unit would not remain in operation for any length of time. Second, the states in which selling subsidiaries are located, might object to the plan because in the case of some commodities a relatively small proportion of expenses are involved in the sales division as compared with the manufacturing division of the enterprise.

The difficulties in administering such a method of allocation appear to be rather formidable. First, as compared with the simpler, but more arbitrary, method of fractional apportionment, the accounting procedure is very complex. Second, the translation of capital investment into equivalent annual expenses raises the whole question of evaluation of property for taxing purposes, which bristles with legal technicalities, e. g., should property be evaluated on the basis of original cost, reproduction costs, or

[9] For discussion of the rule of unity, see P. 20 ff.

prudent investment? Finally, the advocate of separate accounting might suggest that if a detailed allocation is made of expenses, why not do the same for revenues and thereby eliminate the controversial allocation of taxable income to a state in which no net income is earned.

Separate Accounting

The case for separate accounting has been stated in a previous section.[10] The basic concept underlying this method is the treatment of a branch as a separate accounting unit.[11] It is recognized that separate accounting consists not of a single method but of many different methods which will vary according to conditions within an enterprise. The suggestions for the use of separate accounting, therefore, have been based on the assumption that a standard accounting procedure would be followed and few specific recommendations have been made for interstate adoption.

In recommending the adoption of separate accounting as the principal method of allocation, the emphasis has been placed upon the international situation. Furthermore, there are several countries in which this method is already well developed. According to the investigation which is being conducted by Mr. Mitchell B. Carroll for the Fiscal Committee of the League of Nations, "the normal procedure in Germany, Great Britain and the United States is to tax a branch of a foreign enterprise on the basis of its own accounts, provided they are satisfactory or can be properly adjusted."[12] This investigation is world-wide in character and was undertaken for the purpose of formulating principles and methods which would serve as the basis of a multilateral treaty for the elimination of double taxation of this type.[13]

In 1931, a committee of the American Institute of Accountants submitted a preliminary report on the elimination of international double taxation.[14] The report was confined to a statement of the principles which underlie some of the simpler problems of allocation rather than any formulation of accounting methodology for the complex cases. It was the opinion of this committee that each separate establishment or branch should be considered as a separate business enterprise. After all, a taxpayer may convert, by legal means, any branch establishment into a separate business enterprise and he may find it advantageous to do so if the application of tax regulations affecting branches becomes too onerous.

[10] P. 33 ff.

[11] A subsidiary, of course, may be treated as a branch or as a separate concern for taxation purposes. For a discussion of the relationship between the rule of unity and separate entity doctrine, see P. 20 ff.

[12] *Taxation of Foreign and National Enterprises*, League of Nations (1932), P. 21.

[13] For statements of the nature of the investigation, see the Preface to *Taxation of Foreign and National Enterprises*, League of Nations (1932); also, National Tax Association, *Proceedings* (1931), P. 334.

[14] "Report of Special Committee on International Double Taxation," *Bulletin of American Institute of Accountants*, Series B, No. 86, P. 5 ff. (June 15, 1931).

In the formulation of basic principles, three cases were considered by the Committee:

(a) When a concern is engaged in the purchase of goods in one country and the consequent sale of such goods in another country, it may happen that a considerable portion of the profit results from the purchase and assembly of the goods. Under such circumstances, the allocation of all profit to the country of sale might involve an unfair assignment and division of the profits for taxation purposes. This difficulty might be eliminated by the addition to the purchase price of a reasonable buyers commission and/or a reasonable service charge for grading, assembling, etc. "In many cases, there will be within the country of purchase, open market prices applicable to goods properly assembled and graded, which prices would serve as a fair measure of income attributable to that country . . . However, where goods are simply purchased in the open market, it is fair to hold that no profit arises from the mere acts of purchase. The country of purchase, because of the economic benefits derived by that country from the act of purchase, could thus well forego a tax even though a profit might be attributable to the act of purchase."[15]

(b) When a concern is engaged in the manufacture of goods, either partially or wholly, in one country and their partial manufacture and sale, or assembly and sale in another country, the test of allocating the income in the majority of such cases is the "reasonableness of a charge made to the selling unit by the manufacturing unit, and it seems clear that the preferable way to record such transactions is to keep separate sets of books in each country."

(c) When income is derived from services rendered, the principle seems well established that such income has its source where the service is rendered. "This class of cases, however, is subject to many variations and the determination of the amount of income derived from service in any particular jurisdiction is not always easy of solution. There is the question of services being rendered in one country but a portion of the benefit derived accruing to interests located in another country and thus calling for the allocation of a reasonable share of the compensation to each of the two jurisdictions."[16]

To what extent would the method of separate accounting be applicable to the interstate problem? There are many who feel that the interstate and international problems are so different as to warrant or necessitate an entirely different treatment. For instance, in 1931, a committee of the National Tax Association stated that "the problems of income reporting and allocation [interstate and international], while often similar, cannot be said to be identical or to rest on identical principles." The following factors were offered in support of this statement:

[15] Bulletin of American Institute of Accountants, *loc. cit.*
[16] *Idem.* P. 7.

1. Difference in language in international business necessitating generally differences in the financial records of the foreign divisions of a business.
2. Differences in methods of conducting foreign businesses and interstate business.
3. The different theories of profit realization upon which foreign branches and domestic branches are likely to be based.
4. Tariff laws which may affect international but not interstate income taxation.
5. Differences in the competitive objectives and motives in domestic and foreign businesses involving in the case of international businesses frequently such real but intangible elements as race or historical prejudices.
6. Differences in constitutional limitations on the power to tax.[17]

At the same meeting of the Tax Association, however, Mr. M. B. Carroll stated that "the Committee [sub-committee of the Fiscal Committee] contemplates using as a basic method for both international and interstate business that of separate accounting, provided the books reveal the true income. This method should take care of most international cases and also many interstate cases, especially where the corporation is operating in non-contiguous states, or, although operating in contiguous states, finds it advisable to segregate the profits of each jurisdiction."[18]

Regardless of whether or not the international and interstate problems are identical, the investigations of methods of income allocation under national tax systems should shed much light on the question of interstate allocation. From a theoretical standpoint the problems are identical, although obstacles such as were outlined by the Committee of the National Tax Association[19] may necessitate the application of different methods of treatment. The relative merits of separate accounting and fractional apportionment were discussed in another section[20] and further elaboration at this point would be repetitious. However, the fact that separate accounting is adaptable to concerns which engage in international trade does not constitute a sufficient reason for scrapping fractional apportionment within the American states.

The solution of the domestic allocation problem is dependent upon the adoption of a uniform rule. Any one of the three proposals considered in this chapter might be used as a point of departure from present methods. However, the general adoption at present of either the method of separate accounting or that of apportionment according to expenses seems to be highly improbable. Apparently the states prefer the method of fractional apportionment. In many cases, it would be burdensome and expensive for companies to keep separate accounts in the various states. Moreover, separate accounting is unnecessary if approximately the same results can be obtained by using the method of fractional apportionment. If a uniform rule were to be selected, the choice would probably lie between the Massachusetts plan and the plan of the Committee of the National Tax Association.

[17] "Report of Committee on Uniformity and Reciprocity in State Tax Legislation," National Tax Association, *Proceedings* (1931), P. 302.
[18] *Proceedings* (1931), P. 339.
[19] *Ibid.*, P. 339.
[20] Chapter 2.

CHAPTER X

METHODS OF ACCOMPLISHING UNIFORMITY

In this chapter, the emphasis is shifted from the allocation problem as such to the larger question of the methods of accomplishing uniformity in allocation. Should the adoption of a uniform rule be left to the voluntary action of the states through the ratification of interstate agreements, or should the federal government, either directly or indirectly, compel the states to adopt a uniform method? Space limitations preclude all but a brief statement of the types of compulsion and coordinated activity between governmental agencies. Nevertheless, it may suffice to clarify the issues involved in the resort to voluntary or compulsory uniformity. Furthermore, it may show that the allocation problem cannot be solved in isolation from other tax problems. The whole matter turns upon the question of a greater or less degree of centralization, that is, centrifugal versus centripetal tendencies. If the federal government should take over the administration of the corporation income tax, this would have a direct bearing upon the problem of fractional apportionment as a device for distribution of the proceeds. It is from this point of view that the final suggestions are made.

Voluntary Uniformity Inadequate

The opinion seems to prevail widely that the difficulties encountered in the application of non-uniform methods of fractional apportionment could be eliminated through the formulation and ratification of interstate agreements for the use of a uniform rule. Such agreements, however, would not solve one of the chief problems involved in the corporation income tax, *viz.*, the problem of taxing that portion of corporate income arising exclusively, or almost entirely, from interstate commerce.[1] Professor Seligman has said: "when even the economic apportionment to each state of its proper share of revenue from such complex sources is so difficult a matter to accomplish, the problem of fiscal adjustment

[1] The states might, and in many instances do, tax interestate commerce indirectly by using it in the allocation fraction, or though the failure to distinguish properly between intrastate and interstate commerce.

Professor Thomas Reed Powell has stated: "The states can tax property employed in interstate commerce and assess it at a capitalization of what it earns in that commerce. The states can tax gross receipts from interstate commerce if they forego taxing the property. They can tax net income from interstate commerce." "Business Taxes and the Federal Constitution," National Tax Association, *Proceedings* (1925), P. 165. As a result of this condition, according to Professor Powell, it would seem advisable for the states to levy a straight tax on inome from *all* business carried on within a state.

of interstate difficulties by purely state administrative methods may be declared to be well-nigh insoluble."[2]

The attempt to achieve uniformity by voluntary interstate agreements would delay settlement of the allocation problem for many years. It has been shown that twelve different methods of fractional apportionment are followed by the twenty-one states that tax corporate income. The scrapping of eleven of these methods would be accomplished very slowly. It seems doubtful that very many states would voluntarily abandon existing practices and join a movement for the general adoption of a uniform method of allocation. Even if a uniform rule were finally secured in this manner, the problem of interstate commerce would still remain unsolved, as noted previously. Finally, some sort of pressure would have to be exerted for the adoption of the desired rule of allocation in case any of the twenty-seven, non-income-taxing states changed their laws and levied a tax on corporate income. It would seem that a spur to cooperative action in adopting measures of uniformity could only be applied effectively by a central authority.

Nature of Problem Necessitates Compulsory Action

Non-uniform practices prevail in the allocation of corporate income because of the partial perpetuation of the doctrine of state autonomy. Relatively little pressure has been exerted upon the states to adopt uniform methods of taxation. The absence of such pressure accounts for the chaotic situation which was described in previous sections.[3] So long as the bulk of business activity was intrastate in character, the exaltation of states rights was inocuous. Under modern conditions, however, when so much business is of an interstate, and even international, character, the preservation of such a doctrine, even in part, may lead to serious inequities.[4] At present, there are all of the factors which go to make up an obnoxious method of taxation: non-uniformity, competitive allocation or tax grabbing, and objectionable double taxation.

The doctrine of state autonomy is so deeply embedded in the political structure that a redefinition and reassignment of federal and state functions is necessary. Clearly, the solution to this aspect of the problem is of a political, rather than of an economic, nature. The political structure needs to be brought into harmony

[2] Seligman, *Essays in Taxation* (10th ed.) P. 388.

[3] See chapters IV, VI.

[4] See chapter seven. Within recent years, the courts have shown some disposition to place limitations upon state taxing powers which may ultimately lead to uniformity in taxation policies affecting interstate commerce, *e.g.*, *Frick* v. *Pennsylvania*, 268 U. S. 473 (1925); *Rhode Island Hospital Trust Company* v. *Doughton*, 270 U. S. 69 (1926); *Farmers Loan and Trust Company* v. *Minnesota*, 280 U. S. 204 (1930); *Baldwin* v. *Missouri*, 281 U. S. 586 (1930); *Beidler* v. *South Carolina Tax Commission*, 282 U. S. 1 (1930); *First National Bank of Boston* v. *Maine*, 284 U. S. 312 (1932).

with economic conditions. Many of the existing forms of governmental organization, as well as the functions of certain governmental agencies, were designed for a different economic age and a different economic system. For many years, industrial integration has moved by leaps and bounds while governmental integration has remained practically static. It is simply another instance of the lacunae in the law and of the time lag between economic and political changes. According to Professor Leland: "the problems of today call for a very different type of government than we now have. The needs of economic classes, of territories specializing in manufacturing, commerce and agriculture cannot be met by our federal geographical form of government. It is time that the utility of its structure be examined and that it be adapted to current conditions."[5] If the governmental structure were changed to meet modern requirements, the problem of income apportionment would be considered as a national problem. The way would then be paved for the federal government to assume the initiative in promoting uniformity, eliminating competitive allocation, double taxation and the evils of multiple administration.

Types of Compulsion

The question of compelling uniformity may be approached from four different angles, each of which involves a progressive step toward centralization.

In the first place, Congress might pass a law prohibiting double taxation, such as arises out of the application of varying allocation formulae to the same corporation, or to related corporations, operating in several states.[6] The Supreme Court would probably uphold the constitutionality of such legislation. This method possesses merit and would perhaps prove more acceptable to the states than any of the other plans of compulsion, which are described below. Nevertheless, it would not eliminate the problem of interstate commerce,[7] nor that of dual or multiple administration.

Second, the crediting device, which is used in connection with the federal estate tax, might be extended to the corporate income tax; this is an indirect form of compulsion. The proposal for the application of this device to the corporate income tax is not pointed directly at the allocation problem, but it might be used as an instrument in obtaining uniformity by providing that state income taxes could be credited against the federal tax only in case of the adoption of the prescribed rule of allocation.

[5] S. E. Leland, "The Relations of Federal, State and Local Finance," National Tax Association, *Proceedings* (1930), P. 100.
[6] This method was suggested at P. 99.
[7] P. 116.

The use of the crediting principle has been so successful in stimulating uniformity in inheritance taxation,[8] that its extension to the field of corporate taxation has been strongly recommended. This proposal was made by Mr. Mark Graves, of the New York State Tax Commission. Senator Edmonds of Pennsylvania, President of the National Tax Association, has also advocated the crediting of state taxes against those of the federal government. The legislature of the State of North Carolina, on January 19, 1931, passed a joint resolution requesting the appointment of a committee to memorialize Congress that:

> "whenever any state of the Union levies a tax for revenue on any commodity or article upon which the United States government levies a like or similar tax the United States government will remit to the person, firm or corporation paying said tax an amount equal to the tax levied by the state for said purpose upon said commodity or article, provided the state tax does not exceed twenty per cent of the tax levied by the United States government."

Mr. Enslow, who is making an investigation of this problem for the New York State Tax Commission, has stated that:

> "it can readily be seen that, far from being an interference with the sovereignty of the states, the credit provision is a guarantee of, and an assistance to, that sovereignty, since it would allow a state to have an effective income tax. . . . Some of the agricultural states would derive very little revenue from such a tax so that the amount they would receive from an income tax credit might not be a great inducement to them to enact such legislation. There is this to be considered, however, that if they would not gain much from a credit, neither would they lose much from failing to take advantage of such an arrangement."[9]

Commissioner Merrill of the New York State Tax Commission has proposed that the federal rate on corporate net income be increased to seventeen per cent against which the taxpayer would be allowed a credit not exceeding five per cent of the net income for income taxes paid to any state. In the absence of such a levy by any state, the full seventeen per cent would be paid to the federal government, so that there would be a stimulus for all states to adopt an income tax at a rate which would be high enough to absorb the federal credit.

Certain advantages of the crediting device were recognized by Professor Haig in a recent address before the National Tax Association: "the extension of the crediting device may be expected to reduce tax competition, lessen evasion and encourage uniformity. Moreover, its legal foundation is apparently settled. [Florida v. Mellon, 273 U. S. 12 (1927).] Its introduction would involve

[8] Most of the states have adjusted the rates of inheritance taxation so as to absorb the full federal credit of eighty per cent. Furthermore, the Supreme Court has made a substantial contribution to the solution of the problem in a series of significant decisions. See P. 98; also, Note 3, *supra*.
[9] H. R. Enslow, "Shall State Income Taxes be Credited Against the Federal Tax?" (1932) 3 *The Tax Magazine* 85.

less disturbance and friction than either separation of sources or integration."[10]

The advantages of the crediting principle, however, are nullified by its defects. According to Professor Haig, there are a great number of difficult questions and problems which would arise in the extension of this principle to the corporate income tax[11], almost none of which arose in the case of the estate tax credit. "Even if all the technical questions can be answered, however, the crediting device offers at best only the possibility of a partial solution. The wastes of dual administration are not eliminated or even reduced. Neither does it provide a cure for the problem of interstate commerce, the problem of localizing the tax base, or the problem of uneconomical administrative districting."[12]

Third, it has been proposed that the federal government tax all interstate commerce[13] and distribute the proceeds back to the state.[14] This would eliminate the evils of competitive allocation and would solve the problem of interstate commerce, as stated previously.[15] However, it would not abolish dual and multiple administration.

In view of the shortcomings of the three preceding proposals, the only hope of a complete solution seems to lie in the integration of federal and state tax systems. Furthermore it is but a short step from federal taxation of all interstate commerce to the policy of fiscal integration. It would seem advisable to strive for some degree of integration in a direct manner, rather than to use a device which would yield similar results, but in an indirect and awkward fashion. At present, there seems to be a pronounced trend in the direction of fiscal integration, although it will probably be unattainable for many years. Nevertheless, certain implications of the policy should be considered.

In the first place, the program of integration involves "the assignment to the federal government of all those types of taxes in the administration of which it possesses a substantial advantage as compared with the states, with provision for such a division of the yield with the states as is appropriate to the functions assigned to them on the basis of the principle of efficiency."[16] In approaching this problem it is necessary to decide whether the federal government is to assume new functions and consequently new obligations, or whether it will serve merely as the agent of the states in the administration of the taxes. If the change involves the assumption of new functions, there would be a transfer of substantial amounts of revenue from the states to the federal government, which in turn would apportion the revenue among the states for specified purposes, such as schools and highways, according to the standards of actual needs and the economic position of various states. The method of apportioning the yield constitutes the "heart of the problem" of integration and could be worked out only after extensive research and experimentation.

[10] R. M. Haig, "The Coordination of the Federal and State Tax Systems," Reprinted in the *Bulletin* of National Tax Association (December, 1932), P. 72.

[11] A detailed list of questions are enumerated in the address. See Note 10, *supra*.

[12] Haig, *ibid.*

[13] Simeon E. Leland, "The Relations of Federal, State and Local Finance," National Tax Association, *Proceedings* (1930), Pp. 104, 106; J. W. Huston, "Allocation of Corporate Net Income for Purposes of Taxation," 7 *Illinois Law Review* 750 (1932). See also Edwin R. A. Seligman, *Essays in Taxation* (10th edition), Pp. 380–382; H. C. Adams, *The Science of Finance*, (Henry Holt and Company, New York, 1898), P. 495 f.

[14] See P. 121.

[15] P. 116.

[16] Haig, *loc. cit.*

In view of the radical changes involved in the adoption of a system of fiscal integration, a more practicable plan seems to be the resort to opportunistic tactics for the achievement of such a system. This has been accomplished in the field of inheritance taxation. The next step is to centralize the administration of the income tax, although along a different line from that which was followed with the death taxes. Inasmuch as there would be no assumption of new activities, the federal government would act merely as the agent of the states. The federal tax on corporate income would be levied in lieu of state taxes of this type, the proceeds being distributed among the states according to the source of income.[17] But what criteria should be used in determining the source of corporate income? This is the perennial question. The allocation problem that confronts the states at present would be simply transferred to the federal government. However, under federal administration it would involve an allocation of the proceeds of the corporation income tax rather than the allocation of net income among the states for taxation purposes. Such a transference of administration is highly desirable because it would automatically eliminate the problem of non-uniformity and objectionable double taxation by overlapping jurisdictions. It would abolish the evils of dual administration, as well as remove the difficulties of distinguishing between intrastate and interstate commerce. In selecting criteria for determining the source of income, the Massachusetts rule or the plan of the National Tax Association might fit in adequately with the system of integration.

If such a reorganization were effected, many of the problems which seem important now would become irrelevant and insignificant. Many new and baffling questions would arise, to be sure, but a modern technique could be applied in meeting the new conditions. There is every reason for adopting a plan which will eradicate the defects of an out-worn system, even though new problems are created in the process of change.

[17] Edwin R. A. Seligman, *Essays in Taxation* (10th edition), P. 387; R. M. Haig, "The Coordination of the Federal and State Tax Systems," *Bulletin* of the National Tax Association, December, 1932, P. 73; S. E. Leland, "The Relations of Federal, State and Local Finance," National Tax Association, *Proceedings* (1930), P. 104.

Professor Seligman, in making this recommendation, cites several illustrations to show that it is by no means so new or revolutionary a suggestion as it may appear." *Op. cit.*, P. 387. He also cites striking examples of division of tax yields in Germany. *Op. cit.*, P. 665.

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STATE PRACTICES IN ALLOCATING INCOME OF MERCANTILE AND MANUFACTURING CORPORATIONS FOR INCOME TAX PURPOSES AS OF JANUARY 1, 1933[28]

State	Date of adoption of income tax	Legal citation	Title of tax	Basis of tax	Measure of tax	Rate of tax	Date return is due	Figure to be allocated	Method of allocation left to discretion of administrative officials	Separate accounting permitted[2]	Alternative fraction may be submitted	Items subject to specific allocation	Fraction applicable to foreign or domestic corporations	Factors Used In Determining Income Earned Within State: Tangible property	Gross receipts or sales	Payroll	Manufacturing costs	Business	Certain accounts receivable	Shares of stock of other corporations owned	Purchases	Cost value of capital assets	Net cost of sales	Allocation fraction
Arkansas	1929	Act 118 of 1929, Sec. 15, Regulations 7, Art. 362, 364.	Income tax	Income	Domestic corporations: entire net income. Foreign corporations: apportioned net income.	2%	May 15	Total net income (after deduction of items specifically allocated).	X[1]	Yes	No provision	Interest, rentals, royalties and gains from the sale of property.	Foreign		X[3]		X[11]							$\frac{\text{Gross sales within Arkansas}}{\text{Total gross sales}}$ or[3] $\frac{\text{Cost of production within Arkansas}}{\text{Total cost of production}}$
California	1929	Stats. 1929, Chap. 13. Form 105 for Franchise Tax Returns.	Corporation franchise tax.	Privilege of exercising corporate franchise.	Apportioned net income.	4% less offset consisting of 10% of local real estate and all local personal property taxes, but total must not exceed 75% of franchise tax.	Two months and fifteen days after close of fiscal or calendar year.	Net income (same as federal, except for certain adjustments).	X[4]	No provision	No provision	None	Both	X	X	X								$\frac{\text{Average monthly value of real and tangible personal property within State}}{\text{Average monthly value of entire real and tangible personal property}} + \frac{\text{Wages, salaries, commissions and other compensation to employees within State}}{\text{Total wages, salaries, commissions and other compensation to employees}} + \frac{\text{Gross sales within State}}{\text{Total gross sales}} \div 3$
Connecticut	1915	G. S., Revision of 1930, Chap. 74, Secs. 1326, 1327, 1331.	Income tax	Operation of business.	Apportioned net income.	2%	April 1, and, in some cases, 60 days after close of fiscal year.	Net income (same as federal, except for certain adjustments).	Statutory fraction.	No	No	None	Both	X[5]	X[5]									$\frac{\text{Fair cash value of real estate and tangible personal property within state}}{\text{Average monthly value of entire real and tangible personal property}}$ or[5] $\frac{\text{Gross receipts within Connecticut}}{\text{Total gross receipts}}$
Georgia	1929[6]	Laws, Extraordinary Session, 1931, p. 24ff, Income Tax Act.	Income tax	Net income	Apportioned net income.	4%	March 15	Total net income (after deduction of items specifically allocated).	Statutory fraction.	Yes	Yes	Interest, rents and gain from the sale of capital assets or property.	Both	X				X[7]						$\frac{\text{Value of real and tangible personal property within State}}{\text{Value of entire real and tangible personal property}} + \frac{\text{Business within[7] State}}{\text{Total business}} \div 2$
Idaho	1931	Laws, Extraordinary Session, 1931, Chap. 2.	Income tax	Net income	Apportioned net income.	1st \$2,000—1% (after deductions); 2nd \$2,000—2%; 3rd \$2,000—3%; on balance—4%.	On or before March 15, or 15th day of third month following fiscal year.	Total net income (after deduction of items specifically allocated).	X[8]	No provision	No provision	Interest, rentals, royalties and gains from sale of property.	Both	X	X	X								$\frac{\text{Value of real and tangible personal property within State}}{\text{Total real and tangible personal property}} + \frac{\text{Payroll within State}}{\text{Total payroll}} + \frac{\text{Sales within State}}{\text{Total sales}} \div 3$
Massachusetts	1919	General Laws, Chap. 63, Secs. 30–52.	Excise tax[9].	Carrying on of business in the State in corporate capacity.	Apportioned net income and corporate excess.	2½% (after special deductions) \$5 per thousand upon value of corporate excess used in state.	April 1–10.	Net income (same as federal, except for certain adjustments).	Statutory fraction.	Foreign corporations only.	Any of the ratios may be omitted if not applicable to the business.	Interest, dividends and gains from sale of capital assets.	Both	X	X	X								$\frac{\text{Average value of tangible property within State}}{\text{Average value of total tangible property}} + \frac{\text{Wages, salaries, commissions or other compensation to employees within State}}{\text{Total wages, salaries, commissions or other compensation to employees}} + \frac{\text{Gross receipts within State}}{\text{Total gross receipts}} \div 3$[10].
Mississippi	1924	Code 1930, Chap. 124. Return IT, Form 301-W-F, Revised.	Income tax	Corporate income	Net income earned within State.	2½%–6%	March 15	Total net income (after deduction of items specifically allocated).	X[1]	Yes	No provision	Interest, rents and royalties, profits from sale of capital assets and other income earned directly in Mississippi.	Foreign			X[12]						X	X	$\frac{\text{Cost value of capital assets within State}}{\text{Total cost value of capital assets}} + \frac{\text{Expenditures for labor (direct and indirect) within State}}{\text{Total expenditures for labor (direct and indirect)}} \div 2$[13] or $\frac{\text{Net cost of sales[14] within State}}{\text{Total net cost of sales}}$.
Missouri	1917	R. S. 1929, Art. XX	Income tax	Corporation	Net income earned within State.	2%	March 15	Total net income	Statutory fraction	Yes	Yes	None	Both		X			X[17]						$\frac{\text{Gross sales or[17] amount of business transacted wholly within State} + \text{½ of gross sales or[17] ½ of the amount of business transacted partly within and partly without State}}{\text{Total sales or total amount of business transacted}}$
Montana	1917	R. C. Secs. 2296–2300.	Corporation license tax.	Privilege of doing business in State as a corporation.	Net income from business transacted within the State during preceding calendar year.	1%	March 1		Allocation fraction not used.	Required	No	[18]												
New York	1917	Tax Law, Art. 9-A	Franchise tax.	Domestic: for privilege of exercising corporate franchise; Foreign: for privilege of doing business in State.	Apportioned net income for year preceding or a minimum on apportioned issued capital stock.	4½%	July 1	Entire net income (same as federal except for certain adjustments).	Statutory fraction.	Yes	Yes	None	Both	X					X[19]	X[20]				$\frac{\text{Average monthly value of real and tangible personal property within State}}{\text{Average monthly value of total real and tangible personal property}} + \frac{\text{Average monthly value of certain bills and accounts receivable having a situs in New York[19]}}{\text{Total average monthly value of certain bills and accounts receivable}} + \frac{\text{New York proportion of average value of stock of other corporations owned[20]}}{\text{Total average value of stocks of other corporations owned}} \div 3$
North Carolina	1921[15]	Revenue and Machinery Acts, 1931, Art. IV, Secs. 311, 318, 322, 326, 329.	Income tax	Net income	Domestic: Entire[16] net income; Foreign: Apportioned net income.	5½%	March 15	Entire net income.	Statutory fraction.	Yes[21]	No provision	None	Foreign	X	X		X[11]							$\frac{\text{Fair cash value of real and tangible personal property within State}}{\text{Fair cash value of total real and tangible personal property}} + \frac{\text{Cost of manufacturing, collecting, assembling or processing within State}}{\text{Total cost of manufacturing, collecting, assembling or processing}} \div 2$ or[22] $\frac{\text{Fair cash value of real and tangible personal property within State}}{\text{Fair cash value of total real and tangible personal property}} + \frac{\text{Sales within State}}{\text{Total sales}} \div 2$
North Dakota	1919	C. L. Supp. 1913–25, Secs. 2346a5–2346a32 Laws, 1931, Chap. 283.	Income tax	Net income	Apportioned net income.	3%	March 15, or 15th day of third month following close of fiscal year.	Total net income (after certain adjustments).	Statutory fraction.	Yes	No	Interest dividends, rents, royalties (less related expenses) and gains from sale of capital assets.	Both	X	(X)	(X)		X[23]			(X)			$\frac{\text{Average value of tangible property within State}}{\text{Average value of total tangible property}} + \frac{\text{Business transacted[23] within State}}{\text{Total business}} \div 2$
Oklahoma[26]	1931	Laws, 1931 Session, p. 236.	Net income tax.	Net income	Net income	1st \$10,000—2%; 2nd \$10,000—3%; next \$80,000—4%; over \$100,000—5%.	March 15, or on 15th day of third month after end of accounting year.		X[24]															
Oregon	1929	Laws, 1929, as amended 1931, Chap. 427.	Corporation excise tax.	Privilege of doing business in State.	Net income	8% (offset allowed for personal property taxes paid, up to 90% of excise tax).	90 days after end of year.	Total net income	X	Yes	Yes	None	Both	X	X	X								$\frac{\text{Average value of real and tangible personal property within State}}{\text{Average value of total real and tangible personal property}} + \frac{\text{Wages, salaries and other personal service compensation to employees within State}}{\text{Total wages, salaries and other personal service compensation}} + \frac{\text{Gross sales within State}}{\text{Total gross sales}} \div 3$.
South Carolina	1922	Acts, 1927, Act 1; Acts, 1930, Acts 803, 834.	Income tax	Net income	Net income	4½%	15th day of third month after close of accounting period.	Total net income	Statutory fraction	Yes	No	None	Foreign	X	X									$\frac{\text{Fair cash value of real and tangible personal property within State}}{\text{Fair cash value of entire real and tangible personal property}}$ or[25] $\frac{\text{Gross sales within State}}{\text{Total gross sales}}$ or[25] $\frac{\text{Fair cash value of real and tangible personal property within State}}{\text{Fair cash value of entire real and tangible personal property}} + \frac{\text{Gross sales within State}}{\text{Total gross sales}} \div 2$.
Tennessee	1923	Chap. 21, Public Acts, Second Extraordinary Session, 1931.	Corporation excise tax.[9]	Privilege of doing business in State in a corporate capacity.	Apportioned net income.	3%	May 1	Total net income	X	Yes	Yes	None	Both		X									$\frac{\text{Gross sales within State}}{\text{Total gross sales}}$
Utah	1931	Laws, 1931, Chap. 39.	Corporation franchise tax.	Privilege of doing business in State.	Apportioned net income.	3% (property tax offset allowed up to ½ of franchise tax).	March 15th, or 15th day of third month following close of ficial year.	Total net income (after deduction of items specifically allocated).	Statutory fraction.	Yes	Yes	Rents, interest, dividends, and gains from sale of capital assets.	Both	X	X	X								$\frac{\text{Average value of tangible property within State}}{\text{Average value of total tangible property}} + \frac{\text{Expenditures for wages, salaries commissions and other compensation to employees within State}}{\text{Total expenditures for wages, salaries, commissions or other compensation to employees}} + \frac{\text{Gross receipts within State}}{\text{Total gross receipts}} \div 3$.
Vermont	1931	Acts of 1931, Part II, No. 17.	Franchise tax.	Privilege of exercising corporation franchise.	Apportioned net income.	2%	Within 30 days after return to U. S. Treasury Department.	Total net income (after deduction of items specifically allocated).	X[27]					X					X	X				[27].
Virginia	1916	Tax Code, Chap. 6, Secs. 23–66.	Corporation income tax.	Corporation	Net income earned in State.	3%	April 15	Total net income	Statutory fraction.	Yes	Yes	None	Both	X	X									$\frac{\text{Fair market value of real estate and other physical assets within State}}{\text{Fair market value of total real estate and other physical assets}} + \frac{\text{Gross receipts within State}}{\text{Total gross receipts}} \div 2$.
Washington	1932	Initiative Measure, No. 69.	Income tax	Corporate net income.	Apportioned net income.	1%–7%	March 15, or within 75 days after close of fiscal year.	Entire net income (after deduction of items specifically allocated).	Statutory fraction.	Yes	Any one of the three ratios may be omitted with approval of tax commission.	Rentals, royalties, dividends, interest and gains from sale of real or tangible personal property.	Both	X	X		X[11]							$\frac{\text{Value of real and tangible personal property within State}}{\text{Value of total real and tangible personal property}} + \frac{\text{Cost of manufacturing, collecting, assembling or processing goods within State}}{\text{Total cost of manufacturing, collecting, assembling or processing}} + \frac{\text{Sales within State}}{\text{Total sales}} \div 3$.
Wisconsin	1911	Stats. Chap. 71	Income tax	Corporate income	Apportioned net income (income for 1932 or a three year average, whichever is higher for 1933. For 1934, and thereafter, income for a single year).	2%–6%	Within 75 days after close of accounting year.	Total net income (after deduction of items specifically allocated).	Statutory fraction.	Yes	Any one of the three ratios may be omitted with approval of tax commission.	Interest, rents, royalties, dividends and gains from sale of capital assets.	Both	X	X		X[11]							$\frac{\text{Value of real and tangible personal property within State}}{\text{Value of total real and tangible personal property}} + \frac{\text{Cost of manufacturing, collecting, assembling or processing goods within State}}{\text{Total cost of manufacturing, collecting, assembling or processing}} + \frac{\text{Sales within State}}{\text{Total sales}} \div 3$.

[1] Prescribed by Tax Commissioner with approval by the Governor.

[2] The prohibition of a separate accounting will not be upheld if it can be shown that the statutory fraction operates in an arbitrary and discriminatory manner.

[3] Trading or mercantile companies use the gross sales ratio while cost of production ratio is applicable to manufacturing companies.

[4] Formula prescribed in Form 105 for Bank and Corporation Franchise Tax Return.

[5] The property ratio is applicable to companies deriving profits principally from ownership, sale or rental of real estate, or profits principally from manufacture, sale or use of tangible personal property. The sales ratio is applicable to companies deriving profits principally from holding or sale of intangible property.

[6] No method of allocation was provided in the 1929 law. A specific rule, although incomplete, was adopted in the revision of 1931.

[7] Business of the corporation shall be determined according to rules and regulations of the Tax Commissioner.

[8] Apportionment shall be made according to rules and regulations of the Tax Commissioner, "giving consideration to sales, property and payroll and such other factors as may be deemed applicable."

[9] The excise tax denotes the combined corporation income and corporate excess taxes.

[10] Net income is divided into three equal parts and apportioned according to the three ratios.

[11] In general, manufacturing costs are measured by the following items: (a) cost of goods, materials and supplies; (b) labor (direct and indirect); and (c) overhead.

[12] Expenditures for labor (direct and indirect).

[13] Applicable to manufacturing corporations.

[14] Applicable to trading corporations. Turnover, as measured by net cost of sales, must be shown in the return.

[15] Substantial changes in the method of allocation were made in the tax revision of 1931.

[16] A credit is allowed for income taxes paid in other states.

[17] The business ratio is used as an alternative to the sales ratio in cases where sales do not express the volume of business conducted within the State. No measures of the business ratio are provided in the statute.

[18] Certain expenses which cannot be allocated specifically are apportioned according to the ratio of gross income in Montana to total gross income.

[19] Bills and accounts receivable arising from "(a) personal property sold by the corporation from merchandise manufactured by it within this State; (b) personal property owned by the corporation and not manufactured by it within this State but sold by it or its agents and located within the State at the time of the receipt of the order; (c) the purchase or sale of, or trading in, goods, wares or merchandise not located at any place at which the corporation conducted a permanent or continuous business within the State, and where the bills and accounts receivable arose from orders received or accepted by any officer or agent, or at any place of business, in this State; and (d) services performed by any officer, agent or representative of the corporation connected with, sent from, or reporting, either directly or indirectly, to any officer located in this State or at any office located, owned, rented or occupied in this State."

[20] "The value of share stock of another corporation owned by a corporation liable hereunder shall for purposes of allocation of assets be apportioned in and out of the State in accordance with the value of the physical property in and out of the State representing such share stock."

[21] In Hans Rees' Sons v. State of North Carolina (51 Sup. Ct. 385), which involved an application of the 1921 allocation fraction, the United States Supreme Court upheld the use of a separate accounting.

[22] Property and cost of manufacturing ratios applicable to manufacturing corporations; property and sales ratios applicable to trading or mercantile corporations.

[23] The business of the corporation is measured by expenditures for (a) payroll, (b) purchase of goods, materials and supplies; plus (c) receipts from sales.

[24] No allocation provisions are contained in the statute, except that the Tax Commission is authorized to formulate rules and regulations. The first returns were due on March 15, 1932.

[25] Manufacturing corporations use the property ratio; the gross sales ratio is used in case there is no real property within the State, or where the foreign corporation is engaged in buying and selling; the combined property and sales ratios are used when the income of a foreign corporation is derived from the sale of personal property produced (in whole or in part) by the taxpayer without and sold within the State.

[26] The general income tax act of 1931 was declared unconstitutional in Evans v. McCabe, 52 S. W. (2nd) 159 (1932).

[27] No information is available concerning allocation practices. The law became effective December 31, 1931, and the first returns from corporations were not due until April 15, 1932. The type of information required in the tax return indicates that the allocation method will be essentially the same as that of New York.

[28] This chart was published in substantially the present form in Federal and State Tax Systems, p. 1786, Fourth ed. Commerce Clearing House, Inc., Chicago, 1933.

REDUCTION
RATIO
12:1

2.0 mm ABCDEFGHIJKLMNOPQRSTUVWXYZ
abcdefghijklmnopqrstuvwxyz1234567890

1.5 mm ABCDEFGHIJKLMNOPQRSTUVWXYZ
abcdefghijklmnopqrstuvwxyz1234567890

PM-MGP 13"x18"
METRIC GENERAL PURPOSE TARGET
PHOTOGRAPHIC

200 mm

150 mm

100 mm

A4

A5

1.0 mm ABCDEFGHIJKLMNOPQRSTUVWXYZ
abcdefghijklmnopqrstuvwxyz1234567890

1.5 mm ABCDEFGHIJKLMNOPQRSTUVWXYZ
abcdefghijklmnopqrstuvwxyz1234567890

2.0 mm ABCDEFGHIJKLMNOPQRSTUVWXYZ
abcdefghijklmnopqrstuvwxyz
1234567890

2.5 mm ABCDEFGHIJKLMNOPQRSTUVWXYZ
abcdefghijklmnopqrstuvwxyz
1234567890

PRECISION℠ RESOLUTION TARGETS

Century
A&P
1303 Geneva Avenue
St. Paul, MN 55119

4.5 mm ABCDEFGHIJKLMNOPQRSTUVWXYZ
abcdefghijklmnopqrstuvwxyz
1234567890

3.5 mm ABCDEFGHIJKLMNOPQRSTUVWXYZ
abcdefghijklmnopqrstuvwxyz1234567890

ABCDEFGHIJKLMNOPQRSTUVWXYZ

STATE PRACTICES IN ALLOCATING INCOME OF MERCANTILE AND MANUFACTURING CORPORATIONS FOR INCOME TAX PURPOSES AS OF JANUARY 1, 1933[23]

State	Date of adoption of income tax	Legal citation	Title of tax	Basis of tax	Measure of tax	Rate of tax	Date return is due	Figure to be allocated	Method of allocation left to discretion of administrative officials	Separate accounting permitted[2]	Alternative fraction may be submitted	Items subject to specific allocation
Arkansas	1929	Act 118 of 1929, Sec. 15, Regulations 7, Art. 362, 364.	Income tax	Income	Domestic corporations: entire net income. Foreign corporations: apportioned net income.	2%	May 15	Total net income (after deduction of items specifically allocated).	X[1]	Yes	No provision	Interest, rentals, royalties and gains from the sale of property.
California	1929	*Stats.* 1929, Chap. 13, Form 105 for Franchise Tax Returns.	Corporation franchise tax.	Privilege of exercising corporate franchise.	Apportioned net income.	4% less offset consisting of 10% of local real estate and all local personal property taxes, but total must not exceed 75% of franchise tax.	Two months and fifteen days after close of fiscal or calendar year.	Net income (same as federal, except for certain adjustments).	X[4]	No provision	No provision	None
Connecticut	1915	*G. S.*, Revision of 1930, Chap. 74, Secs. 1326, 1327, 1331.	Income tax	Operation of business.	Apportioned net income.	2%	April 1, and, in some cases, 60 days after close of fiscal year.	Net income (same as federal, except for certain adjustments).	Statutory fraction.	No	No	None
Georgia	1929[6]	*Laws*, Extraordinary Session, 1931, p.24ff, Income Tax Act.	Income tax	Net income	Apportioned net income.	4%	March 15	Total net income (after deduction of items specifically allocated).	Statutory fraction.	Yes	Yes	Interest, rents and gain from the sale of capital assets or property.
Idaho	1931	*Laws*, Extraordinary Session, 1931, Chap. 2.	Income tax	Net income	Apportioned net income.	1st $2,000—1% (after deductions); 2nd $2,000—2%; 3rd $2,000—3%; on balance—4%.	On or before March 15, or 15th day of third month following fiscal year.	Total net income (after deduction of items specifically allocated).	X[8]	No provision	No provision	Interest, rentals, royalties and gains from sale of property.
Massachusetts	1919	*General Laws*, Chap. 63, Secs. 30–52.	Excise tax[9]	Carrying on of business in the State in corporate capacity.	Apportioned net income and corporate excess.	2½% (after special deductions) $5 per thousand upon value of corporate excess used in state.	April 1–10.	Net income (same as federal, except for certain adjustments).	Statutory fraction.	Foreign corporations only.	Any of the ratios may be omitted if not applicable to the business.	Interest, dividends and gains from sale of capital assets.
Mississippi	1924	*Code 1930*, Chap. 124. Return IT, Form 301-W-F, Revised.	Income tax	Corporate income	Net income earned within State.	2½%–6%	March 15	Total net income (after deduction of items specifically allocated).	X[1]	Yes	No provision	Interest, rents and royalties, profits from sale of capital assets and other income earned directly in Mississippi.
Missouri	1917	*R. S.* 1929, Art. XX	Income tax	Corporation	Net income earned within State.	2%	March 15	Total net income	Statutory fraction.	Yes	Yes	None
Montana	1917	*R. C.* Secs. 2296–2300.	Corporation license tax.	Privilege of doing business in State as a corporation.	Net income from business transacted within the State during preceding calendar year.	1%	March 1	...	Allocation fraction not used.	Required	No	[18]
New York	1917	*Tax Law*, Art. 9-A	Franchise tax.	Domestic: for privilege of exercising corporate franchise; Foreign: for privilege of doing business in State.	Apportioned net income for year preceding or a minimum on apportioned issued capital stock.	4½ %	July 1	Entire net income (same as federal except for certain adjustments).	Statutory fraction.	Yes	Yes	None
North Carolina	1921[15]	*Revenue and Machinery Acts*, 1931, Art. IV, Secs. 311, 318, 322, 326, 329.	Income tax	Net income	Domestic: Entire[16] net income; Foreign: Apportioned net income.	5½%	March 15	Entire net income.	Statutory fraction.	Yes[21]	No provision	None
North Dakota	1919	*C. L. Supp.* 1913–25, Secs. 2346a6–2346a32 *Laws*, 1931, Chap. 283.	Income tax	Net income	Apportioned net income.	3%	March 15, or 15th day of third month following close of fiscal year.	Total net income (after certain adjustments).	Statutory fraction.	Yes	No	Interest dividends, rents, royalties (less related expenses) and gains from sale of capital assets.
Oklahoma[24]	1931	*Laws*, 1931 Session, p. 236.	Net income tax.	Net income	Net income	1st $10,000—2%; 2nd $10,000—3%; next $80,000—4%; over $100,000—5%.	March 15, or on 15th day of third month after end of accounting year.	...	X[24]	...	...	...
Oregon	1929	*Laws*, 1929, as amended 1931, Chap. 427.	Corporation excise tax.	Privilege of doing business in State.	Net income	8% (offset allowed for personal property taxes paid, up to 90% of excise tax).	90 days after end of year.	Total net income	X	Yes	Yes	None

State	Fraction applicable to foreign or domestic corporations	Factors Used In Determining Income Earned Within State: Tangible property	Gross receipts or sales	Payroll	Manufacturing costs	Business	Certain accounts receivable	Shares of stock of other corporations owned	Purchases	Cost value of capital assets	Net cost of sales	Allocation fraction
Arkansas	Foreign	...	X[3]	...	X[11]	...	...	...	...	...	...	(Gross sales within Arkansas / Total gross sales) or[4] (Cost of production within Arkansas / Total cost of production)
California	Both	X	X	X	...	...	...	...	...	...	...	(Average monthly value of real and tangible personal property within State / Average monthly value of entire real and tangible personal property) + (Wages, salaries, commissions and other compensation to employees within State / Total wages, salaries, commissions and other compensation to employees) [illegible]
Connecticut	Both	X[5]	X[5]	...	...	...	...	...	...	...	...	(Fair cash value of real estate and tangible personal property within state / Average monthly value of entire real and tangible personal property) or[4] (Gross receipts within Connecticut / Total gross receipts)
Georgia	Both	X	...	...	...	X[7]	...	...	...	...	...	(Value of real and tangible personal property within State / Value of entire real and tangible personal property) + (Business within[7] State / Total business) ÷ 2
Idaho	Both	X	X	X	...	...	...	...	...	...	...	(Value of real and tangible personal property within State / Total real and tangible personal property) + (Payroll within State / Total payroll) + (Sales [illegible])
Massachusetts	Both	X	X	X	...	...	...	...	...	...	...	(Average value of tangible property within State / Average value of total tangible property) + (Wages, salaries, commissions or other compensation to employees within [illegible] / Total wages, salaries, commissions [illegible] other compensation to employees [illegible])
Mississippi	Foreign	...	...	X[12]	...	...	...	...	...	X	X	(Cost value of capital assets within State / Total cost value of capital assets) + (Expenditures for labor (direct and indirect) within State / Total expenditures for labor (direct and indirect)) ÷ [illegible]
Missouri	Both	...	X	...	...	X[17]	...	...	...	...	...	(Gross sales or[17] amount of business transacted wholly within State + ½ of gross sales or[17] ½ of the [illegible] transacted partly [illegible] without State) / Total sales or total amount of business transacted
Montana	...	...	...	...	...	...	...	...	...	...	...	
New York	Both	X	...	...	...	...	X[19]	X[20]	...	...	...	(Average monthly value of real and tangible personal property within State / Average monthly value of total real and tangible personal property) + (Average monthly value of certain bills and accounts receivable having a situs in New York[illegible] / Total average monthly value of certain bills and accounts receivable) + [illegible]
North Carolina	Foreign	X	X	...	X[11]	...	...	...	...	...	...	(Fair cash value of real and tangible personal property within State / Fair cash value of total real and tangible personal property) + (Cost of manufacturing, collecting, assembling or processing within State / Total cost of manufacturing, collecting, assembling or processing) ÷ 2 or[illegible] (Fair cash [illegible])
North Dakota	Both	X	(X)	(X)	...	X[22]	...	...	(X)	...	...	(Average value of tangible property within State / Average value of total tangible property) + (Business transacted[illegible] within State / Total business) ÷ [illegible]
Oklahoma[24]	...	...	...	...	...	...	...	...	...	...	...	
Oregon	Both	X	X	X	...	...	...	...	...	...	...	(Average value of real and tangible personal property within State / Average value of total real and tangible personal property) + (Wages, salaries and other personal service compensation to employees within State / Total wages, salaries and [illegible] personal service compensation [illegible])

STATE PRACTICES IN ALLOCATING INCOME OF MERCANTILE AND MANUFACTURING CORPORATIONS FOR INCOME TAX PURPOSES AS OF JANUARY 1, 1933[33]

Basis of tax	Measure of tax	Rate of tax	Date return is due	Figure to be allocated	Method of allocation left to discretion of administrative officials	Separate accounting permitted[2]	Alternative fraction may be submitted	Items subject to specific allocation	Fraction applicable to foreign or domestic corporations	Factors Used In Determining Income Earned Within State: Tangible property.	Gross receipts or sales	Payroll	Manufacturing costs	Business	Certain accounts receivable	Shares of stock of other corporations owned	Purchases	Cost value of capital assets	Net cost of sales	Allocation fraction
me	Domestic corporations: entire net income. Foreign corporations: apportioned net income.	2%	May 15	Total net income (after deduction of items specifically allocated).	X[1]	Yes	No provision	Interest, rentals, royalties and gains from the sale of property.	Foreign		X[3]		X[11]							$\frac{\text{Gross sales within Arkansas}}{\text{Total gross sales}}$ or[3] $\frac{\text{Cost of production within Arkansas}}{\text{Total cost of production}}$
vilege of exercising corporate franise.	Apportioned net income.	4% less offset consisting of 10% of local real estate and all local personal property taxes, but total must not exceed 75% of franchise tax.	Two months and fifteen days after close of fiscal or calendar year.	Net income (same as federal, except for certain adjustments).	X[4]	No provision	No provision	None	Both	X	X	X								$\left(\frac{\text{Average monthly value of real and tangible personal property within State}}{\text{Average monthly value of entire real and tangible personal property}} + \frac{\text{Wages, salaries, commissions and other compensation to employees within State}}{\text{Total wages, salaries, commissions and other compensation to employees}} + \frac{\text{Gross sales within State}}{\text{Total gross sales}}\right) \div 3.$
eration of business.	Apportioned net income.	2%	April 1, and, in some cases, 60 days after close of fiscal year.	Net income (same as federal, except for certain adjustments).	Statutory fraction.	No	No	None	Both	X[5]	X[5]									$\frac{\text{Fair cash value of real estate and tangible personal property within state}}{\text{Average monthly value of entire real and tangible personal property}}$ or[5] $\frac{\text{Gross receipts within Connecticut}}{\text{Total gross receipts}}.$
t income	Apportioned net income.	4%	March 15	Total net income (after deduction of items specifically allocated).	Statutory fraction.	Yes	Yes	Interest, rents and gain from the sale of capital assets or property.	Both	X				X[7]						$\left(\frac{\text{Value of real and tangible personal property within State}}{\text{Value of entire real and tangible personal property}} + \frac{\text{Business within[7] State}}{\text{Total business}}\right) \div 2.$
t income	Apportioned net income.	1st $2,000—1% (after deductions); 2nd $2,000—2%; 3rd $2,000—3%; on balance—4%.	On or before March 15, or 15th day of third month following fiscal year.	Total net income (after deduction of items specifically allocated).	X[9]	No provision	No provision	Interest, rentals, royalties and gains from sale of property.	Both	X	X	X								$\left(\frac{\text{Value of real and tangible personal property within State}}{\text{Total real and tangible personal property}} + \frac{\text{Payroll within State}}{\text{Total payroll}} + \frac{\text{Sales within State}}{\text{Total sales}}\right) \div 3.$
arrying on of business in the State in corporate capacity.	Apportioned net income and corporate excess.	2½% (after special deductions) $5 per thousand upon value of corporate excess used in state.	April 1–10.	Net income (same as federal, except for certain adjustments).	Statutory fraction.	Foreign corporations only.	Any of the ratios may be omitted if not applicable to the business.	Interest, dividends and gains from sale of capital assets.	Both	X	X	X								$\left(\frac{\text{Average value of tangible property within State}}{\text{Average value of total tangible property}} + \frac{\text{Wages, salaries, commissions or other compensation to employees within State}}{\text{Total wages, salaries, commissions or other compensation to employees}} + \frac{\text{Gross receipts within State}}{\text{Total gross receipts}}\right) \div 3$[10].
orporate income	Net income earned within State.	2½%-6%	March 15	Total net income (after deduction of items specifically allocated).	X[1]	Yes	No provision	Interest, rents and royalties, profits from sale of capital assets and other income earned directly in Mississippi.	Foreign			X[12]						X	X	$\left(\frac{\text{Cost value of capital assets within State}}{\text{Total cost value of capital assets}} + \frac{\text{Expenditures for labor (direct and indirect) within State}}{\text{Total expenditures for labor (direct and indirect)}}\right) \div 2$[13] or $\frac{\text{Net cost of sales[14] within State}}{\text{Total net cost of sales}}.$
orporation	Net income earned within State.	2%	March 15	Total net income	Statutory fraction.	Yes	Yes	None	Both		X			X[17]						$\frac{\text{Gross sales or[17] amount of business transacted wholly within State} + \text{½ of gross sales or[17] ½ of the amount of business transacted partly within and partly without State}}{\text{Total sales or total amount of business transacted}}$
rivilege of doing business in State as a corporation.	Net income from business transacted within the State during preceding calendar year.	1%	March 1		Allocation fraction not used.	Required	No	[18]												
Domestic: for privilege of exercising corporate franchise; Foreign: for privilege of doing business in State.	Apportioned net income for year preceding or a minimum on apportioned issued capital stock.	4½ %	July 1	Entire net income (same as federal except for certain adjustments).	Statutory fraction.	Yes	Yes	None	Both	X					X[19]	X[20]				$\left(\frac{\text{Average monthly value of real and tangible personal property within State}}{\text{Average monthly value of total real and tangible personal property}} + \frac{\text{Average monthly value of certain bills and accounts receivable having a situs in New York[19]}}{\text{Total average monthly value of certain bills and accounts receivable}} + \frac{\text{New York proportion of average value of stock of other corporations owned[20]}}{\text{Total average value of stocks of other corporations owned}}\right) \div 3.$
Net income	Domestic: Entire[16] net income; Foreign: Apportioned net income.	5½%	March 15	Entire net income.	Statutory fraction.	Yes[21]	No provision	None	Foreign	X	X		X[11]							$\left(\frac{\text{Fair cash value of real and tangible personal property within State}}{\text{Fair cash value of total real and tangible personal property}} + \frac{\text{Cost of manufacturing, collecting, assembling or processing within State}}{\text{Total cost of manufacturing, collecting, assembling or processing}}\right) \div 2$ or[22] $\left(\frac{\text{Fair cash value of real and tangible personal property within State}}{\text{Fair cash value of total real and tangible personal property}} + \frac{\text{Sales within State}}{\text{Total sales}}\right) \div 2.$
Net income	Apportioned net income.	3%	March 15, or 15th day of third month following close of fiscal year.	Total net income (after certain adjustments).	Statutory fraction.	Yes	No	Interest dividends, rents, royalties (less related expenses) and gains from sale of capital assets.	Both	X	(X)	(X)		X[23]			(X)			$\left(\frac{\text{Average value of tangible property within State}}{\text{Average value of total tangible property}} + \frac{\text{Business transacted[23] within State}}{\text{Total business}}\right) \div 2.$
Net income	Net income	1st $10,000—2%; 2nd $10,000—3%; next $80,000—4%; over $100,000—5%.	March 15, or on 15th day of third month after end of accounting year.		X[24]															
Privilege of doing business in State.	Net income	8% (offset allowed for personal property taxes paid, up to 90% of excise tax).	90 days after end of year.	Total net income	X	Yes	Yes	None	Both	X	X	X								$\left(\frac{\text{Average value of real and tangible personal property within State}}{\text{Average value of total real and tangible personal property}} + \frac{\text{Wages, salaries and other personal service compensation to employees within State}}{\text{Total wages, salaries and other personal service compensation}} + \frac{\text{Gross sales within State}}{\text{Total gross sales}}\right) \div 3.$

				ing business in State.																			
North Carolina.	1921[15]	*Revenue and Machinery Acts*, 1931, Art. IV, Secs. 311, 318, 322, 326, 329.	Income tax..	Net income	Domestic: Entire[16] net income; Foreign: Apportioned net income.	5½%............	March 15.........	Entire net income.	Statutory fraction.	Yes[21]......	No provision....	None............	Foreign.....	X....	X....	....	X[11]....	....	....	....	....	....	....
North Dakota..	1919	*C. L. Supp.* 1913-25, Secs. 2346a6-2346a32 *Laws*, 1931, Chap. 283.	Income tax..	Net income.......	Apportioned net income.	3%.............	March 15, or 15th day of third month following close of fiscal year.	Total net income (after certain adjustments).	Statutory fraction.	Yes.......	No...........	Interest dividends, rents, royalties (less related expenses) and gains from sale of capital assets.	Both......	X....	(X)..	(X)..	....	X[23]....	....	....	(X).	....	....
Oklahoma[24]....	1931	*Laws*, 1931 Session, p. 236.	Net income tax.	Net income.......	Net income.......	1st $10,000—2%; 2nd $10,000—3%; next $80,000—4%; over $100,000—5%.	March 15, or on 15th day of third month after end of accounting year.	....	X[24].....	....	....	....	....	....	....	....	....	....	....	....	....	....	....
Oregon........	1929	*Laws*, 1929, as amended 1931, Chap. 427.	Corporation excise tax.	Privilege of doing business in State.	Net income.......	8% (offset allowed for personal property taxes paid, up to 90% of excise tax).	90 days after end of year.	Total net income..	X.......	Yes.......	Yes............	None............	Both......	X....	X....	X....	....	....	....	....	....	....	....
South Carolina.	1922	*Acts*, 1927, Act 1; *Acts*, 1930, Acts 803, 834.	Income tax..	Net income.......	Net income.......	4½%............	15th day of third month after close of accounting period.	Total net income..	Statutory fraction	Yes.......	No............	None............	Foreign....	X....	X....	....	....	....	....	....	....	....	....
Tennessee.....	1923	Chap. 21, *Public Acts*, Second Extraordinary Session, 1931.	Corporation excise tax.[26]	Privilege of doing business in State in a corporate capacity.	Apportioned net income.	3%.............	May 1...........	Total net income..	X.......	Yes.......	Yes...........	None	Both......	....	X....	....	....	....	....	....	....	....	....
Utah..........	1931	*Laws*, 1931, Chap. 39.	Corporation franchise tax.	Privilege of doing business in State.	Apportioned net income.	3% (property tax offset allowed up to ½ of franchise tax).	March 15th, or 15th day of third month following close of official year.	Total net income (after deduction of items specifically allocated).	Statutory fraction.	Yes.......	Yes...........	Rents, interest, dividends, and gains from sale of capital assets.	Both......	X....	X....	X....	....	....	....	....	....	....	....
Vermont......	1931	*Acts of 1931*, Part II, No. 17.	Franchise tax.	Privilege of exercising corporation franchise.	Apportioned net income.	2%.............	Within 30 days after return to U. S. Treasury Department.	Total net income (after deduction of items specifically allocated).	X[27]......	....	....	....	....	X....	....	....	....	....	X....	X....	....	....	....
Virginia.......	1916	*Tax Code*, Chap. 6, Secs. 23-66.	Corporation income tax.	Corporation.......	Net income earned in State.	3%.............	April 15..........	Total net income..	Statutory fraction.	Yes.......	Yes...........	None...........	Both......	X....	X....	....	....	....	....	....	....	....	....
Washington....	1932	*Initiative Measure*, No. 69.	Income tax..	Corporate net income.	Apportioned net income.	1%-7%..........	March 15, or within 75 days after close of fiscal year.	Entire net income (after deduction of items specifically allocated).	Statutory fraction.	Yes.......	Any one of the three ratios may be omitted with approval of tax commission.	Rentals, royalties, dividends, interest and gains from sale of real or tangible personal property.	Both......	X....	X....	....	X[11]....	....	....	....	....	....	....
Wisconsin.....	1911	*Stats.* Chap. 71.....	Income tax..	Corporate income..	Apportioned net income (income for 1932 or a three year average, whichever is higher for 1933. For 1934, and thereafter, income for a single year).	2%-6%..........	Within 75 days after close of accounting year.	Total net income (after deduction of items specifically allocated).	Statutory fraction.	Yes.......	Any one of the three ratios may be omitted with approval of tax commission.	Interest, rents, royalties, dividends and gains from sale of capital assets.	Both......	X....	X....	....	X[11]....	....	....	....	....	....	....

[1] Prescribed by Tax Commissioner with approval by the Governor.

[2] The prohibition of a separate accounting will not be upheld if it can be shown that the statutory fraction operates in an arbitrary and discriminatory manner.

[3] Trading or mercantile companies use the gross sales ratio while cost of production ratio is applicable to manufacturing companies.

[4] Formula prescribed in Form 105 for Bank and Corporation Franchise Tax Return.

[5] The property ratio is applicable to companies deriving profits principally from ownership, sale or rental of real estate, or profits principally from manufacture, sale or use of tangible personal property. The sales ratio is applicable to companies deriving profits principally from holding or sale of intangible property.

[6] No method of allocation was provided in the 1929 law. A specific rule, although incomplete, was adopted in the revision of 1931.

[7] Business of the corporation shall be determined according to rules and regulations of the Tax Commissioner.

[8] Apportionment shall be made according to rules and regulations of the Tax Commissioner, "giving consideration to sales, property and payroll and such other factors as may be deemed applicable."

[9] The excise tax denotes the combined corporation income and corporate excess taxes.

[10] Net income is divided into three equal parts and apportioned according to the three ratios.

[11] In general, manufacturing costs are measured by the following items: (a) cost of goods, materials and supplies; (b) labor (direct and indirect); and (c) overhead.

[12] Expenditures for labor (direct and indirect).

[13] Applicable to manufacturing corporations.

[14] Applicable to trading corporations. Turnover, as measured by net cost of sales, must be shown in the return.

[15] Substantial changes in the method of allocation were made in the tax revision of 1931.

[16] A credit is allowed for income taxes paid in other states.

[17] The business ratio is used as an alternative to the sales ratio in cases where sales do not express the volume of business conducted within the State. No measures of the business ratio are provided in the statute.

[18] Certain expenses which cannot be allocated specifically are apportioned according to the ratio of gross income in Montana to total gross income.

[19] Bills and accounts receivable arising from "(a) personal property sold by the corporation from merchandise manufactured by it within this State; (b) personal property owned by the corporation and not manufactured by it within this State but sold by it or its agents and located within the State at the time of the receipt of the order; (c) the purchase or sale of, or trading in, goods, wares or merchandise not located at any place at which the corporation conducted a permanent or continuous business within the State, and where the bills and accounts receivable arose from orders received or accepted by any officer or agent, or at any place of business, in this State; and (d) services performed by any officer, agent or representative of the corporation connected with, sent from, or reporting, either directly or indirectly, to any officer located in this State or at any office located, owned, rented or occupied in this State."

[20] "The value of share stock of another corporation owned by a corporation liable hereunder shall for purposes of allocation of assets be apportioned in and out of the State in accordance with the value of the physical property in and out of the State representing such share stock."

[21] In ...
1921 allocation ...
[22] Property and ...
sales ratios ...
[23] The business ...
goods, materials ...
[24] No allocation ...
ized to formulate ...
[25] Manufacturing ...
real property ...
bined property ...
of personal property ...
[26] The general ...
(2nd) 159 ...
[27] No ...
31, 1931, and the ...
tion required in the ...
of New York.
[28] This chart ...
Fourth ed. ...

1%	March 15	Entire net income.	Statutory fraction.	Yes[21]	No provision	None	Foreign	X	X	...	X[11]	...	...	...	...	...	...	$\frac{\text{Fair cash value of real and tangible personal property within State}}{\text{Fair cash value of total real and tangible personal property}} + \frac{\text{Cost of manufacturing, collecting, assembling or processing within State}}{\text{Total cost of manufacturing, collecting, assembling or processing}} \div 2$ or[22] $\frac{\text{Fair cash value of real and tangible personal property within State}}{\text{Fair cash value of total real and tangible personal property}} + \frac{\text{Sales within State}}{\text{Total sales}} \div 2.$
%	March 15, or 15th day of third month following close of fiscal year.	Total net income (after certain adjustments).	Statutory fraction.	Yes	No	Interest dividends, rents, royalties (less related expenses) and gains from sale of capital assets.	Both	X	(X)	(X)	...	X[23]	...	...	(X)	...	...	$\frac{\text{Average value of tangible property within State}}{\text{Average value of total tangible property}} + \frac{\text{Business transacted[23] within State}}{\text{Total business}} \div 2.$
st $10,000—2%; nd $10,000—3%; ext $80,000—4%; ver $100,000—5%.	March 15, or on 15th day of third month after end of accounting year.	...	X[24]	...	...	...	...	...	...	...	...	...	...	...	...	...	...	
% (offset allowed for personal property taxes paid, up to 90% of excise tax).	90 days after end of year.	Total net income	X	Yes	Yes	None	Both	X	X	X	...	...	...	...	...	...	...	$\frac{\text{Average value of real and tangible personal property within State}}{\text{Average value of total real and tangible personal property}} + \frac{\text{Wages, salaries and other personal service compensation to employees within State}}{\text{Total wages, salaries and other personal service compensation}} + \frac{\text{Gross sales within State}}{\text{Total gross sales}} \div 3.$
½%	15th day of third month after close of accounting period.	Total net income	Statutory fraction	Yes	No	None	Foreign	X	X	...	...	...	...	...	...	...	...	$\frac{\text{Fair cash value of real and tangible personal property within State}}{\text{Fair cash value of entire real and tangible personal property}}$ or[25] $\frac{\text{Gross sales within State}}{\text{Total gross sales}}$ or[25] $\frac{\text{Fair cash value of real and tangible personal property within State}}{\text{Fair cash value of entire real and tangible personal property}} + \frac{\text{Gross sales within State}}{\text{Total gross sales}} \div 2.$
%	May 1	Total net income	X	Yes	Yes	None	Both	...	X	...	...	...	...	...	...	...	...	$\frac{\text{Gross sales within State}}{\text{Total gross sales}}$
% (property tax offset allowed up to ½ of franchise tax).	March 15th, or 15th day of third month following close of official year.	Total net income (after deduction of items specifically allocated).	Statutory fraction.	Yes	Yes	Rents, interest, dividends, and gains from sale of capital assets.	Both	X	X	X	...	...	...	...	...	...	...	$\frac{\text{Average value of tangible property within State}}{\text{Average value of total tangible property}} + \frac{\text{Expenditures for wages, salaries commissions and other compensation to employees within State}}{\text{Total expenditures for wages, salaries, commissions or other compensation to employees}} + \frac{\text{Gross receipts within State}}{\text{Total gross receipts}} \div 3.$
%	Within 30 days after return to U. S. Treasury Department.	Total net income (after deduction of items specifically allocated).	X[27]	...	...	...	...	X	...	...	...	...	X	X	...	...	...	[27].
%	April 15	Total net income	Statutory fraction.	Yes	Yes	None	Both	X	X	...	...	...	...	...	...	...	...	$\frac{\text{Fair market value of real estate and other physical assets within State}}{\text{Fair market value of total real estate and other physical assets}} + \frac{\text{Gross receipts within State}}{\text{Total gross receipts}} \div 2.$
%-7%	March 15, or within 75 days after close of fiscal year.	Entire net income (after deduction of items specifically allocated).	Statutory fraction.	Yes	Any one of the three ratios may be omitted with approval of tax commission.	Rentals, royalties, dividends, interest and gains from sale of real or tangible personal property.	Both	X	X	...	X[11]	...	...	...	...	...	...	$\frac{\text{Value of real and tangible personal property within State}}{\text{Value of total real and tangible personal property}} + \frac{\text{Cost of manufacturing, collecting, assembling or processing goods within State}}{\text{Total cost of manufacturing, collecting, assembling or processing}} + \frac{\text{Sales within State}}{\text{Total sales}} \div 3.$
%-6%	Within 75 days after close of accounting year.	Total net income (after deduction of items specifically allocated).	Statutory fraction.	Yes	Any one of the three ratios may be omitted with approval of tax commission.	Interest, rents, royalties, dividends and gains from sale of capital assets.	Both	X	X	...	X[11]	...	...	...	...	...	...	$\frac{\text{Value of real and tangible personal property within State}}{\text{Value of total real and tangible personal property}} + \frac{\text{Cost of manufacturing, collecting, assembling or processing goods within State}}{\text{Total cost of manufacturing, collecting, assembling or processing}} + \frac{\text{Sales within State}}{\text{Total sales}} \div 3.$

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[14] Applicable to trading corporations. Turnover, as measured by net cost of sales, must be shown in the return.

[15] Substantial changes in the method of allocation were made in the tax revision of 1931.

[16] A credit is allowed for income taxes paid in other states.

[17] The business ratio is used as an alternative to the sales ratio in cases where sales do not express the volume of business conducted within the State. No measures of the business ratio are provided in the statute.

[18] Certain expenses which cannot be allocated specifically are apportioned according to the ratio of gross income in Montana to total gross income.

[19] Bills and accounts receivable arising from "(a) personal property sold by the corporation from merchandise manufactured by it within this State; (b) personal property owned by the corporation and not manufactured by it within this State but sold by it or its agents and located within the State at the time of the receipt of the order; (c) the purchase or sale of, or trading in, goods, wares or merchandise not located at any place at which the corporation conducted a permanent or continuous business within the State, and where the bills and accounts receivable arose from orders received or accepted by any officer or agent, or at any place of business, in this State; and (d) services performed by any officer, agent or representative of the corporation connected with, sent from, or reporting, either directly or indirectly, to any officer located in this State or at any office located, owned, rented or occupied in this State."

[20] "The value of share stock of another corporation owned by a corporation liable hereunder shall for purposes of allocation of assets be apportioned in and out of the State in accordance with the value of the physical property in and out of the State representing such share stock."

[21] In *Hans Rees' Sons v. State of North Carolina* (51 Sup. Ct. 385), which involved an application of the 1921 allocation fraction, the United States Supreme Court upheld the use of a separate accounting.

[22] Property and cost of manufacturing ratios applicable to manufacturing corporations; property and sales ratios applicable to trading or mercantile corporations.

[23] The business of the corporation is measured by expenditures for (a) payroll, (b) purchase of goods, materials and supplies; plus (c) receipts from sales.

[24] No allocation provisions are contained in the statute, except that the Tax Commission is authorized to formulate rules and regulations. The first returns were due on March 15, 1932.

[25] Manufacturing corporations use the property ratio; the gross sales ratio is used in case there is no real property within the State, or where the foreign corporation is engaged in buying and selling; the combined property and sales ratios are used when the income of a foreign corporation is derived from the sale of personal property produced (in whole or in part) by the taxpayer without and sold within the State.

[26] The general income tax act of 1931 was declared unconstitutional in *Evans v. McCabe*, 52 S. W. (2nd) 159 (1932).

[27] No information is available concerning allocation practices. The law became effective December 31, 1931, and the first returns from corporations were not due until April 15, 1932. The type of information required in the tax return indicates that the allocation method will be essentially the same as that of New York.

[28] This chart was published in substantially the present form in *Federal and State Tax Systems*, p. 170f, Fourth ed. Commerce Clearing House, Inc., Chicago, 1933.

VITA

The author of this study was born in 1902. He graduated from the high school at Bellevue, Texas, in 1919. He received the A. B. degree from Texas Christian University in 1924, part of his under-graduate work having been done at the University of Texas. During 1924–26, he was a Teaching Fellow in Economics at the University of California and received the A. M. degree from that institution in 1926. During 1926–29, he was an instructor in Economics at Princeton University. Since 1929, he has been an instructor in the Department of Economics at Columbia College, Columbia University. In 1930, he was appointed New York State Fellow in Taxation at Columbia University.

He has published the following: "The Status and Certain Tests of Uniformity in Allocating Corporate Income," *Bulletin of National Tax Association.* January, 1932, Vol. 17, No. 4; *Outline of Economics,* (Students Outline Series). Longmans, Green and Company. 1933; Comprehensive Status Table, "State Practices in Allocating Income of Mercantile and Manufacturing Corporations for Income Tax Purposes as of January, 1933," *Federal and State Tax Systems.* P. 170f. Commerce Clearing House, Inc., Chicago, 1933. Fourth ed.

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